

United States House of Representatives
Committee on Financial Services
Washington, D.C. 20515

September 16, 2011

Memorandum

To: Members, Committee on Financial Services

From: Committee Staff

Subject: Capital Markets and Government Sponsored Enterprises Subcommittee
Hearing on "Legislative Proposals to Facilitate Small Business Capital
Formation and Job Creation"

The Subcommittee on Capital Markets and Government Sponsored Enterprises will hold a hearing on "Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation," at 10:00 a.m. on Wednesday, September 21, 2011, in Room 2128 of the Rayburn House Office Building.

This will be a two-panel hearing. Ms. Meredith Cross, Director, Division of Corporation Finance, U.S. Securities and Exchange Commission (SEC), will testify on the first panel. The second panel will include the following witnesses: Mr. Vincent Molinari, Founder & CEO, GATE Technologies LLC; Mr. Barry Silbert, Founder & CEO, SecondMarket, Inc.; Mr. Matthew H. Williams, Chairman and President, Gothenburg State Bank, on behalf of the American Bankers Association; Mr. William D. Waddill, Senior Vice President and Chief Financial Officer, OncoMed Pharmaceuticals, Inc., on behalf of the Biotechnology Industry Organization; Mr. A. Heath Abshire, Commissioner, Arkansas Securities Department on behalf of the North American Securities Administrators; and Ms. Dana Mauriello, President, ProFounder.

Background

Even though the SEC's mission includes the promotion of capital formation, which the SEC acknowledges "is necessary to sustain economic growth," the agency's critics have charged that it has not given sufficient priority to improving the environment for capital formation. In his September 8, 2011 speech to a joint session of Congress, President Obama noted that "small businesses are where most new jobs begin" and pledged to "cut away the red tape that prevents too many rapidly-growing start-up companies from raising capital and going public." In a fact sheet issued in connection with the speech, the Administration offered these specific proposals to foster capital formation:

Reducing Regulatory Burdens on Small Business Capital Formation: As part of the President's Startup America initiative, the Administration will pursue efforts to reduce the regulatory burdens on small business capital formation in ways that are consistent with investor protection. This includes working with the SEC to explore ways to address the costs that small and new firms

face in complying with Sarbanes-Oxley disclosure and auditing requirements. The administration also supports establishing a “crowdfunding” exemption from SEC registration requirements for firms raising less than \$1 million (with individual investments limited to \$10,000 or 10% of investors’ annual income) and raising the cap on “mini-offerings” (Regulation A) from \$5 million to \$50 million. This will make it easier for entrepreneurs to raise capital and create jobs.

This hearing will explore legislative proposals aimed at encouraging “crowdfunding” and providing relief for small firms from onerous Sarbanes-Oxley requirements.¹ This hearing will also examine three other legislative proposals that will facilitate capital formation and create jobs.

Capital Formation and Job Creation

Capital formation is necessary for job creation. A study last year found that “every \$1 billion in capital spending is responsible for approximately 19,643 jobs including both direct and indirect effects.”² The link between capital formation and job creation is further demonstrated by a survey of small business owners in which “71 percent said they estimate they could grow their revenues by 25 percent over the next 12 months – if they had access to the credit or capital necessary to finance their growth plans,” but that “[w]ithout that cash injection, the owners predict, on average, only a 10 percent growth over the next year.”³ Unfortunately, many small companies—which have created nearly 65 percent of all new jobs over the last 15 years⁴—find it difficult to obtain the capital necessary to expand and hire new employees.

Companies obtain capital through borrowing or equity financing. Because banks have tightened their lending standards in the wake of the economic crisis, there is less credit available to fund growth. Equity financing, in which investors purchase ownership stakes in a company in exchange for a share of the company’s future profits, allows companies to obtain funds without having to repay specific amounts at particular times. The tightening of credit has made equity financing all the more important as a means of providing small companies with the capital they need to grow and create jobs. This hearing will examine proposals that would make it easier for companies to obtain equity financing.

Legislative Proposals

H.R. 2167 - Private Company Flexibility and Growth Act

Section 12(g) of the Securities Exchange Act of 1934 (the “Exchange Act”) requires issuers to register equity securities with the SEC if those securities are held by 500 or more record holders and the company has total assets of more than \$10 million. SEC Chairman Schapiro has explained that Section 12(g) was enacted to improve investor protection by extending to the larger companies in the over-the-counter market the same requirements

¹ The third initiative mentioned in the fact sheet—raising the Regulation A offering threshold—would be addressed by enacting H.R. 1070, which was ordered favorably reported to the House by voice vote on June 22, 2011 (H. Rept. 112-206).

² Keybridge Research, *An Analysis of the Business Roundtable’s Survey on Over-the-Counter Derivatives*, April 14, 2010.

³ Sharon Bernstein, *Many businesses want to expand resources*, Los Angeles Times, July 27, 2010.

⁴ SBA Office of Advocacy, *Small Business Economy Frequently Asked Questions* (January 2011).

that apply to companies listed on an exchange.⁵ After a company registers with the SEC under Section 12(g), it must comply with all of the Exchange Act's reporting requirements.⁶

The shareholder threshold—which has not been adjusted since it was adopted in 1964—has become an impediment to capital formation for small startup companies that are innovative and create jobs. These companies often remain private to maintain greater flexibility and control, and to avoid the increased costs associated with being a public company. To attract talented employees and conserve capital for research and development, startup companies often award their employees stock options to offset lower salaries. If the company is successful and those options vest, the holders of those options become equity holders, and they are counted against the registration threshold. Because private companies are taking much longer to go public, employees' stock options are vesting before the company goes public; as a result, a small private company may find itself subject to the same requirements as a listed company.

Barry Silbert, the founder & CEO of SecondMarket, points out the shareholder threshold has resulted in two unintended consequences.⁷ First, the threshold “has created a disincentive for private companies to hire new employees, or acquire other businesses for stock, as these private companies are fearful of taking on too many shareholders.” Second, the threshold “discourages companies from providing stock option-based compensation to employees, removing one of the great economic incentives attracting the country's best and brightest employees to startups.”

To address these problems, Representative Schweikert introduced H.R. 2167, the “Private Company Flexibility and Growth Act,” to raise the threshold for mandatory registration under the Exchange Act from 500 shareholders to 1,000 shareholders for all companies. This bill would also exclude accredited investors and securities held by shareholders who received such securities under employee compensation plans from the 1,000 shareholder threshold.

H.R. 1965 – To amend the securities laws to establish certain thresholds for shareholder registration, and for other purposes.

As a result of the increasing costs of public company registration, many community banks have determined that deregistration is in the best interests of their shareholders. But in order to deregister, community banks must have fewer than 300 shareholders. As a result, community banks must often buy back shares to deregister, which reduces the access of small banks to capital and deprives small communities of an opportunity to invest in local companies.

To address the obstacles that small banks face in maintaining access to capital, Representative Himes introduced H.R. 1965 to amend Section 12(g) of the Exchange Act by

⁵ Statement of The Honorable Mary Schapiro, Chairman, U.S. Securities and Exchange Commission, *The Future of Capital Formation: Hearing Before the House Comm. On Oversight and Government Reform* (May 10, 2011), available at http://oversight.house.gov/images/stories/Testimony/5-10-11_Schapiro_Capital_Formation_Testimony.pdf.

⁶ The reporting requirements include filing annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and proxy statements on Schedule 14A.

⁷ Statement of Barry E. Silbert, Founder and CEO, SecondMarket, *The Future of Capital Formation: Hearing Before the House Comm. On Oversight and Government Reform* (May 10, 2011), available at http://oversight.house.gov/images/stories/Testimony/5-10-11_Barry_Silbert_Capital_Formation_Testimony.pdf.

raising the threshold that triggers registration from 500 to 2,000 record holders for banks or bank holding companies. The bill would also modify the threshold for deregistration under Sections 12(g) and 15(d) of the Exchange Act for a bank or a bank holding company from 300 to 1,200 shareholders.

H.R. 2940 - Access to Capital for Job Creators Act

The Securities Act of 1933 requires that any offer to sell securities must either be registered with the SEC or meet an exemption. Regulation D Rule 506 is an exemption that allows companies to raise capital as long as they do not market their securities through general solicitations or advertising. This prohibition on general solicitation and advertising has been interpreted to mean that potential investors must have an existing relationship with the company before they can be notified that unregistered securities can be purchased. Requiring potential investors to have an existing relationship with the company significantly limits the pool of potential investors and severely hampers the ability of small companies to raise capital.”

On September 15, 2011, Representative Kevin McCarthy introduced H.R. 2940, the “Access to Capital for Job Creators Act,” which makes the exemption under Regulation D Rule 506 available even if securities are marketed through a general solicitation or advertising if the purchasers are “accredited investors.” Chairman Schapiro has pointed out that the ban on solicitation “was designed to ensure that those who would benefit from the safeguards of registration are not solicited in connection with a private offering.” But if only “accredited investors” are allowed to purchase the security, the ban on solicitation is unnecessary because those investors do not require the same “safeguards” that less sophisticated investors do. To qualify as an accredited investor, an individual must have a net worth exceeding \$1 million, excluding his or her primary residence, or an annual income exceeding \$200,000 in each of the two most recent years. As Mr. Silbert has noted, the SEC and Congress “recognize that sophisticated, accredited individual and institutional investors have greater capacity for risk and do not require the enhanced protections provided to the average retail investor.” The legislation would allow companies easier access to capital without putting less sophisticated investors at risk.

H.R. 2930 - Entrepreneur Access to Capital Act

“Crowdfunding” is an increasingly popular method of capital formation in which “groups of people pool money, typically comprised of very small individual contributions, to support an effort by others to accomplish a specific goal.”⁸ Current SEC regulations impede this innovative and lower-risk form of financing, because they prohibit general solicitation and advertisements for non-registered offerings and cap the number of shareholders for non-registered companies at 500. Various state laws also raise barriers to crowdfunding.

To enable crowdfunding to develop and flourish, Representative McHenry introduced H.R. 2930, the “Entrepreneur Access to Capital Act,” on September 15, 2011. Similar to the recommendation circulated by the Obama Administration on September 8, 2011, this legislation would create a crowdfunding exemption from SEC registration. The bill would exempt offerings of up to \$5 million, so long as an individual’s investment is equal to or less than the lesser of \$10,000 or 10% of the investor’s annual income. The

⁸ Letter from The Honorable Mary Schapiro, Chairman, U.S. Securities and Exchange Commission to The Honorable Darrell Issa, Chairman, House Committee on Oversight and Government Reform (April 6, 2011), available at <http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf>.

individual investment restrictions are identical to the Administration's recommendation, but the total offering amount is \$5 million instead of \$1 million. Because the potential risk to investors is better gauged by the size of the individual's investment rather than the size of the offering, the benefits of increasing the offering ceiling to \$5 million outweigh any negative effects on investor protection. The legislation also exempts crowdfunding from shareholder caps and preempts state laws.

H.R. _____ - Small Company Job Growth and Regulatory Relief Act of 2011

Section 404(b) of the Sarbanes-Oxley Act requires the auditor of a publicly-held company to attest to and report on management's assessment of its internal controls. In 2007, recognizing the extremely high costs of compliance with 404(b), the SEC provided "smaller reporting companies" with exemptions from (or alternatives to) Section 404(b).⁹ A "public" company qualifies as a "smaller reporting company" if its market capitalization is less than \$75 million, or, if the market capitalization cannot be determined, less than \$50 million in revenue. Some have pointed out that the current thresholds are too low, because \$75 million is a very small market capitalization. As a result of the low threshold, the exemption has no practical value: virtually no company that was considering going public would benefit from "small reporting company" status because it would not go public if it did not expect to exceed \$75 million market capitalization in the near-term.

The draft legislation of the "Small Company Job Growth and Regulatory Relief Act of 2011" offered by Representative Fincher expands the exemption from Section 404(b) in three ways. First, the legislation increases the market capitalization threshold for a full 404(b) exemption from \$75 million to \$500 million. Second, the legislation provides that any company with a market capitalization between \$500 million and \$1 billion that registers with the SEC after the date of enactment can defer compliance with Section 404(b) for five years; after five years, the company can opt out of Section 404(b) compliance by a majority vote of its shareholders. Third, the legislation provides that a public company with a market capitalization between \$500 million and \$1 billion that has been complying with Section 404(b) may opt out of further Section 404(b) compliance by a majority vote of its shareholders.

William H. Fincher, Chairman, House Small Business Committee, H.R. 7500

⁹ Section 989 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) made permanent the SEC exemption from Section 404(b) for companies with a market capitalization below \$75 million and instructed the SEC to conduct a study, which was submitted to Congress on April 22, 2011, on whether the exemption should be increased from \$75 million to \$250 million.