LEGISLATIVE PROPOSALS TO FACILITATE SMALL BUSINESS CAPITAL FORMATION AND JOB CREATION

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

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CONTENTS

Page

Hearing held on:
  September 21, 2011 1
Appendix:
  September 21, 2011 53

WITNESSES

WEDNESDAY, SEPTEMBER 21, 2011

Abshure, Heath, Arkansas Securities Commissioner, on behalf of the North American Securities Administrators Association, Inc. (NASAA) 29
Cross, Meredith B., Director, Division of Corporation Finance, U.S. Securities and Exchange Commission, accompanied by Lona Nallengara, Deputy Director 10
Mauriello, Dana, Co-Founder and President, ProFounder 31
Molinari, Vincent R., Co-Founder and Chief Executive Officer, GATE Technologies, LLC 33
Silbert, Barry E., Founder and Chief Executive Officer, SecondMarket 35
Waddill, William D., Senior Vice President and Chief Financial Officer, OncoMed Pharmaceuticals, Inc., on behalf of the Biotechnology Industry Organization (BIO) 36
Williams, Matthew H., Chairman and President, Gothenburg State Bank, on behalf of the American Bankers Association (ABA) 38

APPENDIX

Prepared statements:
  Abshure, Heath 54
  Cross, Meredith B. 66
  Mauriello, Dana 85
  Molinari, Vincent R. 100
  Silbert, Barry E. 110
  Waddill, William D. 127
  Williams, Matthew H. 133

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Garrett, Hon. Scott:
  Written statement of Burroughs & Chapin Company, Inc. 140
  Written statement of the Credit Union National Association (CUNA) 143
  Written statement of the Independent Community Bankers of America (ICBA) 147
  Written statement of the U.S. Chamber of Commerce 149
Frank, Hon. Barney:
  Written statement of the CFA Institute, the Center for Audit Quality, and the Council of Institutional Investors 151

LEGISLATIVE PROPOSALS TO FACILITATE SMALL BUSINESS CAPITAL FORMATION AND JOB CREATION

Wednesday, September 21, 2011

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:06 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Schweikert, Royce, Manzullo, Biggert, McCarthy of California, Pearce, Posey, Fitzpatrick, Hayworth, Hurt, Stivers, Dold; Waters, Sherman, Maloney, Perlmutter, Donnelly, Himes, Peters, and Ellison.

Ex officio present: Representative Frank.

Also present: Representatives Fincher and McHenry.

Chairman GARRETT. Good morning. This hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises is called to order.

And before I proceed, I seek unanimous consent that non-subcommittee members, Mr. Fincher and Mr. McHenry, will be allowed to take part today and also give opening statements as well. Without objection, it is so ordered.

We would also like to welcome the newest member of the subcommittee, the gentleman from California, Mr. McCarthy.

Mr. MCCARTHY OF CALIFORNIA. Thank you, Mr. Chairman.

Chairman GARRETT. And with that, we will begin with opening statements. I yield myself 3 minutes.

Before that, I would like to welcome our witnesses. I do look forward to your testimony in a little while, after we have run through all this, on a number of proposals that will encourage capital formation and job creation all across the country.

A couple of weeks ago, as part of the job plan that he outlined at his speech over at the Joint Session of Congress, the President included some ideas that, in the case of Congressman Schweikert's bill, we have passed out of this committee already, and in some other cases are similar to proposals that we will be considering today.

So I am pleased that we have a bipartisan momentum, it would seem, behind efforts to tap into the potential for American entrepreneurs to build companies and to create jobs.

Many of the existing rules and regulations in the area of capital formation were, as always, well-intentioned at the time they were first established, but have sometimes been in place now for years and years, actually decades, and are due for a review.

And so while the President did not end up including any capital formation proposals in his legislative language that he sent up to the Hill, we have five specific bills that we will be considering at today's hearing that we think can help jump-start the economy.

Let's do a quick run-down of them.

H.R. 2167, the Private Company Flexibility and Growth Act, introduced by my Mr. Schweikert, would raise the threshold for mandatory registration with the SEC from 500 to 1,000, if it was signed into law, and would be the first time the shareholder threshold has been adjusted since way back in 1964.

We will also consider a similar proposal today from Congressman Himes that pertains to smaller banks; he just took it down a little bit different road.

Also, Congressman Patrick McHenry has a proposal under consideration today. His bill is called the Entrepreneur Access to Capital Act. What would it do? It would enhance the President's proposals on encouraging so-called crowdfunding, an innovative phenomenon that can tap into social networking tools, where many investors are able to basically pool smaller investments together, get them all together, without having to grapple with the regulations of the SEC and all the costs that go along with that.

Also, the gentleman from California who was just introduced, Mr. McCarthy, has a bill. That is the Access to Capital for Job Creators Act and will also be on the docket, so to speak, today.

As a former small business owner himself, he is an expert in this area and is no stranger to the challenges that they face. So his legislation provide more flexibility in soliciting accredited investors for private offering.

And finally, I will wrap it up here; the newest member of the full Financial Services Committee, Mr. Fincher, has a draft proposal for consideration today that I am really interested in.

During the consideration of Dodd-Frank, I worked closely on a bipartisan basis with my late colleague from New Jersey, John Adler. That was a proposal which was ultimately included in the final bill to permanently exempt smaller companies from having to comply with the burdens of SOX 404(b).

Mr. Fincher's proposal would raise the market capitalization threshold for companies fully exempt from 404(b) compliance from the $75 million that we had, to $500 million, and provide further flexibility in 404(b) compliance for companies from $500 million to the $1 billion range.

So all of these proposals are common-sense ideas, I think, to remove unnecessary regulations, which is what the Administration wants to do, from the shoulders of small businesses while unleashing American entrepreneurs to do what they do best: create jobs and help the economy grow.

As I mentioned earlier, it is my hope and belief that most, if not all of these bills really should, at the end of the day, get bipartisan support.

I appreciate the committee's attention. With that, the gentleman from Massachusetts is recognized for 5 minutes.

Mr. FRANK. Thank you, Mr. Chairman. I agree that we should be moving in a direction of reducing unnecessary regulation, particularly on smaller entities. And we have already worked on things.

I believe we have an agreement between the parties, for instance, on Mr. Schweikert's bill on Regulation A, which I assume will be coming to the Floor soon. We support that. On our side, Mr. Himes has a bill that I believe is widely supported. And there are others that we will be working on.

I agree with much of what we have today. I have two points. One, I am less enamored of further reducing the reach of Sarbanes-Oxley. I think Sarbanes-Oxley is not a generalized statute dealing with audits. I think that has a particular importance. The Congress did vote in the bill last year. And I didn't vote for the amendment, but it is now a law. We have raised them up to $75 million.

I believe, and many in the corporate community have said that Sarbanes-Oxley—obviously, by its name, it is clearly a bipartisan measure—enhanced capital formation, because one of the things we have had from time to time is a lack of confidence on the part of investors.

Sarbanes-Oxley is a great confidence builder. There were predictions that it was going to have a very negative effect on capital formation in America back when it was passed. And I don't believe that has been the case. I think it has been somewhat positive.

The other area that I want to say—we can, on some of these bills, there is room for debate about the level: $1 million is too low in the crowdfunding, but $5 million may be too high. Maybe there are some intermediate things you can do, but I generally agree with the thought of increasing it. But where we may have a sharper difference is on the question of the preemption of State laws.

That was an issue with regard to the Reg A bill. And I was glad that we are able to work that out. We have a study coming. But I do believe that State securities administrators have been helpful.

And I would put it in this context. We have had a disagreement among ourselves about what level of funding the SEC should get, while even the most optimistic projections recognized that the SEC will not have enough money to do everything it theoretically is charged with doing. The Boston Consulting Group study talked about prioritizing.

I think it would be a great mistake to reject the voluntary help that States are prepared to give us in enforcement, especially since in my experience—I come from a State which has an excellent securities administrator. In our case, he is the Secretary of the Commonwealth. He is an elected official. And his most important duty is to be the security administrator, I believe. And he has been very constructive.

What you get, I think, is a level of enforcement and investor protection that you may not get elsewhere. The SEC has the mandate of maintaining a good market. The SEC has broader responsibilities.

It has been my experience in general that at the State level, individual concerns, whether they be consumer concerns or investor concerns, get attention that is sometimes lost down here where we are doing mega policy.

And I think that the macro gets a lot of attention here. The micro doesn't always get as much attention for understandable reasons. Everything is a competition for resources and attention.

I think the States have been doing a good job of this. Yes, you need to recognize the need for national markets. But particularly where we talk about investor protection, where we are talking about anti-fraud protection, I am against the trend of preempting State laws that we have seen from time-to-time.

And again, this is a bipartisan issue. The North American Securities Administrators Association (NASAA) works together in a pretty bipartisan way, and I think they make a very useful contribution.

So I am in favor of reducing some of the SEC registration requirements on the smaller entities. That, in itself, helps the SEC focus better on the broader systemic issues. I don't extend that to Sarbanes-Oxley, which has a very specific purpose.

But I also believe that my own confidence in our ability to do this at the Federal level is strengthened by knowing that the States are there to do the anti-fraud and investor protection. And I would hope that would be the mix we could get, that we would reduce the paperwork at the Federal level, but not diminish the ability of the States to serve that protective function.

And I thank you, Mr. Chairman, for the time.

Chairman GARRETT. I thank the gentleman.

The gentleman from Arizona.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

During the August break, we spent a lot of time visiting companies that were attempting to grow, trying to find ways to capitalize. We would hear two stories: one, a fear of certain regulations that may or may not be coming, but may be in promulgation; and two, access to capital. It is one of the reasons I am actually somewhat overjoyed with the progress we are making here.

This happens to be one of those moments where we are actually understanding that this will help create jobs. And guess what? We are actually, on many of these, working through some of the partisan divide.

To the ranking member and his staff, on a couple of our pieces of legislation, they have been very forthright in their concerns. And we really appreciate their working with our staff, because this really is one of those occasions where we are going to hopefully be disciplined, move bills through the process that do good things, and actually help in the definition of what is access to capital.

In the old days, we used to think it was walking into our neighborhood bank. In today's world, it is something much more complicated, when you think of Mr. McHenry's cloud sourcing of raising money, and some of the other definitions here.

I am hoping this becomes some of the future of how we help capitalize these small and medium-sized businesses.

Thank you, Mr. Chairman.

Chairman GARRETT. And I thank the gentleman.

The gentlelady from New York for 2 minutes.

Mrs. MALONEY. Thank you, Mr. Chairman, for convening this hearing.

And welcome to all of the witnesses. I am so pleased to see that there are so many here today from the private sector to tell us what we need to do to help them grow and expand the economy.

We are looking at several legislative proposals to enable smaller businesses to better grow, create jobs, and boost our economy. And certainly, that is the top of the list of President Obama's address to Congress and I would say both sides of the aisle, creating jobs.

So I am pleased that we are going to study these bills today. They will all try to provide some relief to fledging businesses. And I look forward to working with my colleagues to advance them.

During Dodd-Frank, I worked with my colleagues from New Jersey, Representatives Adler and Garrett, to extend the implementation period of Section 404(b) of Sarbanes-Oxley for smaller public companies.

In Dodd-Frank, companies under $75 million were exempted from 404(b). And I would like to note that 60 percent of all public companies have market capitalization of under $75 million. So I believe that we have the appropriate balance there.

I am interested in supporting Mr. Himes' bill, and not only Mr. Schweikert's Reg A, but H.R. 2167 seems to be a good approach to allowing small businesses to grow and go public on their own. Too often, they have to sell in order to raise liquidity. That doesn't help jobs. That doesn't help growth. That doesn't help the overall economy.

I feel that this is the number one issue in our country now, job creation. And I look forward to learning more about these proposals and supporting some of them.

Thank you, Mr. Chairman.

Chairman GARRETT. And I thank the gentlelady.

Mrs. Biggert is recognized for 1 minute.

Mrs. BIGGERT. Thank you, Mr. Chairman. And good morning and thank you all for being here today.

I think we can all agree that access to capital is an absolute necessity for job creation. According to a recent Small Business Administration survey, 71 percent of small businesses said they could increase their revenues by 25 percent or more if they had access to additional capital. These additional revenues would allow companies to expand and hire additional employees.

Unfortunately, the current regulatory environment remains a roadblock to businesses by strangling access to capital. Recently imposed regulations have led directly to banks tightening their lending standards and the reduction of credit, so badly needed.

In addition to streamlining these burdensome new regulations and providing the certainty banks need to resume lending, it is imperative that we, on this committee, enact sound policies that will allow businesses to grow using additional sources of financing.

We must explore all options to facilitate capital formation, reduce the onerous effects of Sarbanes-Oxley on small businesses, and reduce the regulatory obstacles to overcrowding.

I yield back.

Chairman GARRETT. And the gentlelady yields back.

Mr. Himes for 3 minutes.

Mr. HIMES. Thank you, Mr. Chairman.

Let me begin by thanking the witnesses. The participation of the SEC is going to be really critical in what I think is a really technical and fiddly endeavor that we are embarking on here.

The United States has the most efficient and liquid capital markets in the world, seizures like we have seen in the last couple of years notwithstanding. But I do think we can do better. I will never participate in the blanket anti-regulatory crusade that unfortunately we see from the other side of the aisle.

I think getting the balance of regulation, particularly in financial services, is critical. But I am very open to the possibility, having reviewed, for example, initial public offering data over the last couple of years, that there are some rigidities there that are probably not just explained by additional volatility and risk in the market.

I think we can do better. I am open to the possibility that Sarbanes-Oxley is not perfect, and that the securities laws that were initially established in 1933 and 1934 could evolve and adapt to be more germane to today's markets.

And of course, that the litigation environment that rises up around these laws could, in fact, have a counterproductive and dampening effect on companies' access to capital, which is so critical right now to job creation.

I am also intrigued by the governance questions that are involved here. I believe that even though the private equity industry comes in for a drubbing in this room, that private equity investors, inasmuch as they put people on the boards of directors of the companies that they own, provide a level of accountability and shareholder advocacy on those boards that you don't often see.

But, of course, your mission and our most important task must be to make sure that we don't open the door to retail investors, to the widows and orphans getting hurt by fraud or misstatement. That has to be our first objective.

Not surprisingly, I am a believer in my own bill, H.R. 1965. The financial institutions that would be allowed registration exemptions are in an extraordinarily regulated environment. I take some comfort in that; they are much more regulated than most other commercial entities. I am a co-sponsor of Congressman Schweikert's bill because I think it is a nice evolution of the 1933 and 1934 Acts.

I have profound concerns though about crowdfunding and, in particular, the general solicitation exemption therein. I can imagine a scenario where the Internet is used to get people all over the country to send $5,000 to a snake oil salesman.

I don't know the answer, but all of these things are at risk. It is fiddly and it is complicated. And I hope that you will help us understand what the trade-offs are, so that we come out of this in a bipartisan fashion, having improved the capital markets and created liquidity while protecting investors.

Thank you, and I yield back the balance of my time.

Mr. FRANK. Mr. Chairman, if you will yield for a second, let me just point out, the chairman was not being lax in ignoring the clock. We had extra time, and I had him give it to Mr. Himes. So the chairman was accommodating us.

I don't want other Members to complain that they didn't get the extra minute. That came out of our time.

Chairman GARRETT. Thank you.

The gentleman from California is recognized for 2 minutes.

Mr. MCCARTHY OF CALIFORNIA. Thank you, Chairman Garrett. I appreciate you convening this hearing to examine legislative proposals to facilitate small business capital formation and job creation.

Small businesses are the engine of the American economy. They represent 99.7 percent of all employer firms and employ more than half of all private sector employees.

It doesn't take close examination to these statistics to come to the conclusion that the solution to our national high unemployment must include a plan to allow for robust small business growth.

In order to flourish, entrepreneurs and small business owners need fewer regulatory restrictions and greater access to capital to start and grow companies and get more people working.

Unfortunately, onerous Federal regulations dampen both innovation and access to capital because of the restrictions and compliance burden they place on these enterprises. That is why I have introduced H.R. 2940, the Access to Capital for Job Creators Act.

It removes the solicitation prohibition contained in Rule 506 of Regulation D of the Securities Act to give small businesses another way to access private capital by allowing them to widely seek funds from the entire pool of wealthy SEC-accredited investors without requiring them to go through the full SEC registration process.

I believe that the legislative proposals the committee is exploring today are vital steps forward in promoting job creation and economic growth. By unshackling entrepreneurs and small businesses from excess Federal regulations, our economy job creation engine will once again put us back on the path to prosperity.

And I yield back.

Chairman GARRETT. Thank you.

The gentleman, Mr. Ellison, is recognized for a minute.

Mr. ELLISON. Thank you, Mr. Chairman.

The House is soon going to consider a continuing resolution to fund the government after the fiscal year ends next week. And I remain concerned about the funding levels for the SEC in the upcoming fiscal year. The current House proposal for SEC funding is about $222 million less than the President's request. This budget shortfall will make it harder, not easier, for the SEC to do its job and to implement important reforms in Dodd-Frank.

Underfunding today will cause delays and undermine the work on overcoming derivatives markets and also limit the number of enforcement investigations the SEC can pursue.

So while I urge my colleagues to support full funding, I look forward to hearing what the SEC witness has to say today.

Thank you very much.

Chairman GARRETT. And I want to yield at this point 30 seconds to—

Mr. FRANK. Thank you, Mr. Chairman. I just got a copy of a letter signed by the Center for Audit Quality, the CFA Institute, and the Council of Institutional Investors, opposing the bill to raise the limits further on who is covered by Sarbanes-Oxley. Let me just read it briefly, and I ask to be able to put it in the record.

Chairman GARRETT. Without objection, it is so ordered.

Mr. FRANK. “The Center for Audit Quality, the Council of Institutional Investors, and the CFA Institute are writing to urge you to resist efforts to further weaken SOX by exempting even more public companies from compliance with Section 404(b) of the Act, which requires an independent audit of a company’s assessment of its internal controls as a component of its financial statement audit.

“Indeed, effective internal controls have become more central to the financial statement audit, a fact that has contributed to an increase in overall audit quality in the years since the passage of the Sarbanes-Oxley Act.”

And it says, “We believe that all investors should receive equal protections.” They quote surveys from investors talking about the benefits in Sarbanes-Oxley. As I said, it is signed by the CFA Institute, the Center for Audit Quality, and also the Council of Institutional Investors, Mr. Mahoney. And I ask that it would be put into the record, as you have already given me permission.

Thank you.

Chairman GARRETT. I thank the gentleman.

The gentlelady from New York is recognized for 1 minute.

Dr. HAYWORTH. Thank you, Mr. Chairman, and I appreciate our colleagues’ comments regarding the necessity to, in essence, assess the cost-benefit ratio of regulations. Are we truly doing good things for investors and assuring their safety, while also not impeding the formation of capital or access to capital. And it does feel over the years that we have aired on the side of impeding access.

In particular, I am concerned about small businesses’ ability to raise capital. So I was encouraged by SEC Chairman Mary Schapiro, who last week said that she would work with us regarding issues such as decimalization, the global research settlement, and the general lack of market makers for small capital stocks.

So I hope that we can work together to ensure that liquidity and price discovery can be facilitated in ways that can truly again grow jobs and facilitate enterprise. And I look forward to your comments.

Welcome back, Ms. Cross, to the committee. And I am sure we can work together to make good things happen for our small businesses.

Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. The gentlelady yields back.

Mr. Dold is recognized for 1 minute.

Mr. DOLD. Thank you, Mr. Chairman. I want to thank you for holding the hearing on this important topic.

President Obama and congressional Republicans and Democrats all agree that one of the largest obstacles to job growth and economic recovery is capital formation. And I would argue that is specially true for small business capital formation.

As a small business owner myself, I personally understand the challenges of business expansion, hiring, meeting a payroll and a budget, and managing cash flow. And capital formation is a crucial component in achieving these important small business objectives. But the reality is that small businesses right now all across our country are struggling for capital.

Some capital formation problems are caused by factors the Federal Government can’t directly or immediately affect. But there are other factors that the government can directly and immediately affect, starting with scrutinizing our existing regulations to determine which ones no longer make sense in our current economic situation and in our current practical marketplace realities.

So I look forward to hearing from our witnesses about correcting regulations that are creating an unduly restrictive capital formation environment, while also maintaining necessary investor protections.

With that, Mr. Chairman, I yield back.

Chairman GARRETT. And the gentleman yields back.

Mr. McHenry for 1 minute.

Mr. MCHENRY. Thank you, Mr. Chairman.

As we know, most startups have a difficult time accessing the capital they need. Most small businesses began using a credit card or a home equity line of credit. In fact, my father started his own business on a credit card. We are grateful for that.

But in these tough times, these challenges are twofold. First, fewer people have access to credit lines or home equity sufficient to start a small business. And second, a small businesses is highly burdened with a credit card, financing it with a credit card with a high rate of interest. Thus, most business ideas never make it past the dinner table.

The Entrepreneur Access to Credit Act simply heeds the President's call to cut the red tape for startups and allow everyday investors to connect with entrepreneurs. In today's fast-paced world of information and innovation, all Americans, rather than just high- net-worth individuals, should be able to invest in the next Google, Groupon, or even their local coffee shop.

Furthermore, State law will be preserved under this bill, dealing with anti-fraud laws at the State level.

With that, thank you so much, Mr. Chairman, for holding this hearing.

Chairman GARRETT. And the gentleman yields back.

Mr. Fincher is recognized for, I believe, the final 2 minutes.

Mr. FINCHER. Thank you, Mr. Chairman, for the time and opportunity to join the subcommittee hearing today.

As you know, I have submitted the discussion draft to expand Sarbanes-Oxley 404(b) exemptions for small and mid-sized companies with a market capitalization of less than $500 million.

Supporters of increasing the $75 million cap believe that duplicative audit requirements hinder many companies from going public. Going public provides opportunities for companies to raise desperately needed capital in order to expand, reinvest, and create jobs.

Opponents argue that changing the auditing requirements would lead to corporate fraud and shift us back to the days of Enron and WorldCom.

Let me be clear; I am not talking about doing away with the corporate audits or internal controls, just auditing of the internal controls of companies that could use their scarce resources to expand their business.

By raising market capitalization, it helps companies create jobs, but also preserves the goal of Sarbanes-Oxley, which ensures that large and complex companies, which brought us Sarbanes-Oxley in the first place, continue to be subject to these additional audits.

I look forward to the testimony today.

And thank you for your time, Mr. Chairman.

Chairman GARRETT. And I thank the gentleman as well.

Now then, to the panel. We welcome Ms. Cross to the panel. She is the Director of Division of Corporation Finance at the SEC. You will be recognized for 5 minutes. Obviously, your full written testimony will be made a part of the record.

Ms. Cross?

STATEMENT OF MEREDITH B. CROSS, DIRECTOR, DIVISION OF CORPORATION FINANCE, U.S. SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY LONA NALLENGARA, DEPUTY DIRECTOR

Ms. CROSS. Chairman Garrett, Ranking Member Waters, and members of the subcommittee, my name is Meredith Cross, and I am the Director of the Division of Corporation Finance at the Securities and Exchange Commission. Joining me today is Lona Nallengara, Deputy Director of the Division.

We are pleased to testify on behalf of the Commission on the topic of capital formation and, in particular, the Commission's small business capital formation initiatives and the broader capital formation regulatory review that the staff is undertaking.

Our written testimony also discusses the internal controls audit requirement. I note that a number of the members of the subcommittee have introduced bills addressing many of these topics, and we look forward to discussing those with you today and in the future.

The SEC's mission is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. Companies of all sizes need cost-effective access to capital to grow and develop. And the Commission recognizes that any unnecessary regulations may impede their ability to do that.

At the same time, the Commission must seek to ensure that investors have the information and protections necessary to give them the confidence they need to invest in our markets. Investor confidence in the fairness and honesty of our markets is critical to the formation of capital.

A few months ago, Chairman Schapiro instructed the staff to take a fresh look at some of our offering rules, develop ideas for the Commission to consider that may reduce the regulatory burdens on small business capital formation in a manner consistent with investor protection.

The staff's review is focusing on a number of areas, including the number of shareholders and other triggers for public reporting, the restriction on general solicitation in private offerings, and restrictions on communications in public offerings.

We are committed to carefully considering these areas and developing thoughtful recommendations for the Commission consistent with the goals of facilitating capital formation and protecting investors.

In this regard, we look forward to receiving the input of the Commission's recently formed Advisory Committee on Small and

Emerging Companies, which includes representatives from a range of small and emerging companies and investors in those types of companies with real-world experience under our rules.

Our written testimony provides a more extensive update on our review, but I will briefly discuss a few of our efforts in this area.

Chairman Schapiro has asked the staff to review the Section 12(g) triggers for public reporting by non-listed companies and the characteristics of companies that should be subject to public reporting obligations.

Under our current rules, the Section 12(g) trigger generally is 500 shareholders of record and $10 million in assets. Section 12(g) was adopted in 1964 following a rigorous special study of the securities markets in the early 1960s, commissioned by Congress and conducted by the Commission. Some have called for changes to the Section 12(g) threshold in light of the significant changes in the securities markets since the enactment of Section 12(g).

To facilitate the Commission's review of the issues related to the thresholds for public reporting, and those for leaving the reporting system, the staff is undertaking a robust study like the one conducted when Section 12(g) was enacted. The study should help the Commission determine whether and how now the current thresholds should be updated in light of changes in companies, shareholders, and markets.

Chairman Schapiro also has asked the staff to review the restrictions our rules impose on communications in private offerings, in particular the restrictions on general solicitation. Some have cited the restriction on general solicitation as a significant impediment to capital raising.

At the same time, others support the restriction on general solicitation on the grounds that it helps prevent securities fraud by, for example, making it more difficult for fraudsters to find potential victims or unscrupulous issuers to condition the market.

In analyzing whether to recommend changes in this area, the staff is considering next steps, including a possible concept release for the Commission to seek the public's input on the advisability and the costs and benefits of retaining or relaxing the restrictions on general solicitation.

We also are assessing our rules and the regulatory burdens they impose with respect to communications in public offerings. Over the years, the Commission has taken steps to facilitate continued communication around public offerings.

In 2005, the Commission significantly liberalized the rules governing communications by the largest companies during public offerings. The staff is reviewing these rules and our experience with them to see whether any of the liberalizations should be adapted for smaller public companies.

Finally, as a part of our overall capital formation regulatory review, the staff is considering regulatory questions posed by new capital raising strategies such as crowdfunding, and the scope of our existing rules for small business capital raising such as the Regulation A exemption.

Thank you for inviting us to appear before you today. We will be happy to answer any questions you may have.

[The prepared statement of Ms. Cross and Mr. Nallengara can be found on page 66 of the appendix.]

Chairman GARRETT. And again thanks, Ms. Cross, for being here today. Thank you for your testimony. I assume we will have a whole slew of questions along the lines of legislation.

Let us just begin where you sort of started out, with regard to the SEC setting up this advisory committee on small and emerging companies. Quickly, how do you define a small company?

Ms. CROSS. Companies with a market capital of $250 million.

Chairman GARRETT. Okay. So we set up or you have set up a new committee, an advisory committee on this. Now, this advisory committee, as I look at things, is in addition to your Office of Small Business. Would that be overlapping in some responsibilities what the Office of Small Business would do, briefly?

Ms. CROSS. The Office of Small Business, of course, is staffed with lawyers within the SEC. So we get the real-world experience from the advisory committee in helping us figure out what we should do.

Chairman GARRETT. Right.

Ms. CROSS. So they will work together. The Small Business Office will support the advisory committee in its work.

Chairman GARRETT. Okay. But then on top of this, you also have the annual forum, which I guess is statutorily required.

Ms. CROSS. That is correct.

Chairman GARRETT. And for how long have you been having those annual forums?

Ms. CROSS. I believe over 15 years.

Chairman GARRETT. Yes. Maybe like 2 or 3 decades.

Ms. CROSS. It did quite well, yes.

Chairman GARRETT. So those meet annually. The last one was—it would have been in 2010. Can you tell us how many recommendations came out of that forum? And how many recommendations that came out of that forum did the SEC actually take and issue rule changes from?

Ms. CROSS. I don't know the exact number of recommendations. They do issue a large number of recommendation.

Chairman GARRETT. Okay.

Ms. CROSS. I can't say that any of them have been specifically enacted.

There were a number of them in, I think the forum before the last one, that were part of the small business initiatives. That would have been in 2007. The small business initiatives included a number of forum recommendations.

We are currently going through the forum recommendations as a part of our current initiatives. So we hope to be able to move on some of them in this effort we are under now.

Chairman GARRETT. So how many over the last couple of years have actually gone through not just the process, but actually ended up in the final rulemaking?

Ms. CROSS. We have not done any of them—

Chairman GARRETT. Okay.

Ms. CROSS. —on the most recent forum.

Chairman GARRETT. All right. So with the new advisory committee, can you tell us briefly what the process is? Is there a deadline, since we are already getting almost all the way through 2011, looking back to 2010, and we haven't seen that done?

Is there going to be a deadline with regard to the new advisory committee, as far as when they come up with their rules or when they come up with their recommendations, and when, if any of those recommendations will actually be submitted, they will go through the rule process?

Ms. CROSS. I appreciate your question. I think what we are doing right now is developing the list of the priority questions we would like them to help us analyze.

So instead of sending them off to think about ideas and come back with a report, we are hoping to get pretty real-time feedback from them on the different ideas that are currently being discussed and how helpful they would be and what changes would be needed to implement those specific ideas.

So I would say this will be real-time, hopefully, help from them on looking at these ideas.

Chairman GARRETT. What does that mean, real-time?

Ms. CROSS. We are currently discussing with the chairs of the committee the questions we would like them to take up first. So hopefully, they will be able to get us feedback on the ideas in the next few months.

Chairman GARRETT. Obviously, you know where I am coming from on this.

Ms. CROSS. I understand.

Chairman GARRETT. You can have all these committees in the world, and we have committee meetings all the time. And people always ask, when does actual legislation get through and eventually get signed into law? It is the same thing here.

We are going to be concerned that we are going to take up time and energy and staff time with the SEC. I think it is appropriate that they look at this. But if we are here a year from now and we are saying dialogue and they are saying, "We are still looking at it," you can see our concern.

Another area on this, as far as setting up the committee, is with Sarbanes-Oxley, SOX. I understand—the President comes out with a White Paper that says we need to make some of these reforms, reduce regulation, what have you. And so now as part of this effort, a new committee was formed at SEC to take a look at SOX.

I guess I am taken aback a little bit with regard to that, that this committee is taking a look at recommendations with regard to SOX. This is not a new issue as far as that is concerned.

You are puzzled.

Ms. CROSS. Oh, I am puzzled. I apologize. I am not aware of a committee that has been formed at the SEC to look at SOX. So I guess that is unclear to me.

I think the small business advisory committee that was just formed, that has not been on the list of, so far, priority items for them—

Chairman GARRETT. Okay.

Ms. CROSS. —because the SOX level is set by Congress.

Chairman GARRETT. Right.

Ms. CROSS. And so we have not—Congress changed the SOX level in Dodd-Frank.

Chairman GARRETT. Okay.

Ms. CROSS. And so we implemented a rule to implement what Congress—

Chairman GARRETT. What Congress expected you to do.

Ms. CROSS. Congress directed us to do a study of Section 404 for companies between $75 million and $250 million, which the staff completed and posted on the—

Chairman GARRETT. I understand.

Ms. CROSS. And right now, GAO is doing a follow-up study as directed by Dodd-Frank. Maybe all of those different studies are what you are referring to.

Chairman GARRETT. We will get back to you.

Thank you, Ms. Cross.

The gentlelady from New York is recognized.

Mrs. MALONEY. On the Schweikert and the Himes bills, unlike the Schweikert bill, the Himes bill only applies to banks and bank holding companies. How many banks would be eligible to de-register under this proposal? And how many banks would be affected by this change?

Do you have any sense? And should the shareholder of record definition be revised to only include individual investors?

Ms. CROSS. Thank you for your question.

On the number of community banks that would be exempted as a result of the provision, I don't have that data. We are in the process of gathering data through our 12(g) study. I think it would be a significant percentage of the small community banks.

On who should count as shareholders of record, we think that is a very important question and one that we need to get updated data on. We would like to know the make-up of shareholders of the public companies of different sizes and also private companies. So we are in the process of looking at that now.

Mrs. MALONEY. Can the SEC raise the shareholder threshold on its own, the way it has raised the asset limits from $1 million to $10 million?

Ms. CROSS. I have been advised by our Office of General Counsel that we do have authority under the 1934 Act as currently in effect to raise the level.

In addition, the question of how do you count holders would have significant impacts on the level, because we can define holders of record. And so if we say you either do or don't look through various intermediaries, for example, or we say you don't count certain holders, that would have the practical impacts of changing it.

Mrs. MALONEY. If you can raise it, is there any reason why you have not?

Ms. CROSS. We just began the studies of this. We started in the late spring. As I mentioned in my opening remarks, when the levels were put in there with a robust study directed by Congress, the SEC has to go through the rigorous rulemaking process in order to make changes like that.

If Congress makes the change, it will be in place, of course. If we need to do it, we need to do it through the process that would be expected, with public comment and the like.

Mrs. MALONEY. Are you planning to put it out for public comment?

Ms. CROSS. Following completion of the study, when we know what would be reasonable to recommend, then I would expect that the Commission would want to come forward with something to provide the thresholds. But, obviously, I can't commit the Commission. I am just the staff.

Mrs. MALONEY. And does any evidence suggest that $10 million is the appropriate asset threshold at which to require SEC registration?

Ms. CROSS. I think that is a very fair question and part of what we would be looking at. For example, for banks, $10 million is obviously not a meaningful measure, since a bank's assets include its loans.

For other companies, it may be more reasonable, although it may need to go up. It has been in place since 1992. And it may also be reasonable to look at revenues. It may be reasonable to look at any number of other measures and see what are the kinds of companies that should be subject to public reporting.

Are they only employee-held? There could be any number of things that are very important to this analysis, many of which Congress is currently considering in your legislation.

Mrs. MALONEY. And could you go over what benefits investors experience when a company is registered with the SEC?

Ms. CROSS. There is very important benefits. The way the securities laws are structured, investors are able to invest in companies of their choosing based on full and fair disclosure about those companies.

The SEC doesn't decide who can be a public company and what investors can invest in. Instead, they leave it up to the investors' good judgment, based on having a full and fair disclosure document, with the financial statements and the management information and the risks that the companies face.

So those are things that come through our public reporting system and are valuable to investors in making investment decisions.

Mrs. MALONEY. My time is running out, but is it appropriate to exclude accredited investors and employees from shareholder numbers?

Ms. CROSS. I would like to first address the employee question. The one thing I would want to have Congress considering when looking at the employee question is, if somebody is an employee at a company and they have invested heavily in the company and they lose their job and the company goes under, that would be pretty devastating.

So you would want to make sure that if you go that route, there is other information available to the employee, so that they can keep an eye on whether their employer is, in fact, doing well.

I am not saying that information necessarily has to be disclosed publicly. But at least the employee, it would be better for them to have information about their company's financial condition if they have both their job and their investments in the company.

Mrs. MALONEY. And should a shareholder include broker-dealers holding on behalf of shareholders or only individual investors?

Ms. CROSS. That is an important question we are currently considering. Right now, you do only count at the broker-dealer level instead of the beneficial owners.

For some companies, that could mean they have tens of thousands of investors but only count as 100. We are particularly concerned about that in the OTC markets, where there is no public reporting, and there is trading with really no information. That is one of the areas that we would like to get a handle on.

Comparing that to a company that is a pre-IPO company, where everybody is a record-holder and it is really only 499, that is a pretty big distinction that we want to get a good look at. That seems like not a good place to be. And that is one of the things that the staff would like to address.

Mrs. MALONEY. My time has expired. Thank you.

Ms. CROSS. Thank you.

Chairman GARRETT. And I thank the gentlelady.

The gentleman from Arizona is recognized.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

Sorry, Ms. Cross. First, I know my staff owes some of your staff a thank you for exchanging information, okay. Yes. You always point at the lawyer, right?

Ms. CROSS. Yes.

Mr. SCHWEIKERT. You have the committees and you have been taking input on saying, what are we doing, particularly in that $250 million and under point? What can we do to expand access to capital?

You see some of the bills that are before you today. Any other ideas that both would come to either regulatory or you need statutory change that come to the forefront of thought? And it is sort of an open-ended question.

Ms. CROSS. It is an open-ended question. I think it is a good question that we are currently considering. I would say the one area, which wouldn't really be something you likely would legislate in, but I think could make a big difference is with our current rules for public offerings, we have a large number of very small reporting companies that do need access to capital.

They are complying with the rules. They are providing information. The reforms we adopted in 2005 that really free up their communications and the offering techniques for the largest companies have worked quite well. And so one of the things the staff would really be interested in doing is exploring, and we are currently exploring whether we can make some of those available to small companies.

If the benefit of being a reporting company is that you have quicker access to capital, that is very important. And so we would very much like to see if there are things we can do in the registered market to help companies have more cost-effective access to capital.

With regard to the bills that are pending, the Commission hasn't taken a position on the bills, and so I have to defer on that. But there are a number of very important ideas in these bills that I think, depending if they are implemented in a way that carefully balances the cost and benefits and keeps investor confidence up, they also could provide real benefits.

Mr. SCHWEIKERT. Now, Ms. Cross, I want to solicit if you have any of those ideas that we can grab, I can take credit for them and start running through the process, you just let me know.

Ms. CROSS. Absolutely, absolutely.

Mr. SCHWEIKERT. It is sort of a side question, particularly as we are trying to get a little more creative here. We are also looking at much smaller organizations.

From your standpoint as a regulator, using the Internet, using some of the technologies and access to information we have today that, let's face it, when a lot of these rules were promulgated did not exist. How much is that playing into the thought, the design of future regulations? And how much should that be playing into what we are designing here today?

Ms. CROSS. The Internet presents tremendous opportunities to be able to reach investors who could provide access to capital for companies. It also presents tremendous opportunities for fraudsters to open up, steal your money, and disappear.

So the key here is it is critically important to all we are doing right now in looking at this regulatory area, because we want to make sure that we take advantage of what is good and come up with safeguards so that we don't erode investor confidence for the dangers.

I think in the area of private offerings, for example, we have heard from many that it is very frustrating that they can't use an open Web site in order to find accredited investors for their private offerings. That is the restriction on general solicitation that has been discussed.

That obviously is very much impacted by the Internet and other ways to find investors.

Mr. SCHWEIKERT. Ms. Cross, and I love that term "fraudsters," even in the crowdfunding bill, there are many of us who believe sunlight, information is in many ways one of the greatest regulators because of the speed and flow of information.

How do we use that if I am going to go put my $500 into this investment through something like Mr. McHenry's legislation, but also a robust ability to say, "Oh, I am going to just also do a quick search and get information that is posted about that company." And it is a slightly different thought process than how we have regulated in the past.

It is like I had this concern that as we are designing this, we are also designing something that creates a velocity of information and sort of egalitarian information, as well as a regulatory environment.

Ms. CROSS. I think that with regard to how to structure any particular exemption, the ability to access information will be important. And coming up with an oversight system will be important, on a cost-effective basis though. So I think that is something we would be weighing with regard to any of these exemptions.

Mr. SCHWEIKERT. Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. The gentleman yields back.

The gentleman from Colorado is recognized.

Mr. PERLMUTTER. Thank you, Mr. Chairman, and thanks for this hearing today.

Ms. Cross, we thank you for your testimony.

There are several ideas that I believe deserve merit. Mr. Schweikert has a bill that involves increasing the number of potential purchasers in Reg A. Mr. Himes has a bill that I think deserves a lot of review and merit.

But I think we all have to step back for a second. My questions are going to be more directed to the next panel. But I think, as you said, confidence is what is key here in capital formation. We have the chicken and the egg: demand; capital; and credit—those three things.

And which comes first, capital or demand, or credit and demand? But we have to watch out in terms of capital formation that we don't cause people who want to purchase stock or extend some kind of financing to businesses that they lose confidence.

In the Denver Post, it seems like they must be looking at the chairman's agenda, because they always have a story right on target. The headline is, "Hard Times Make for Soft Targets." And so as we go through this, I think we have to really maintain our attention towards not getting defrauded.

As we push towards capital formation and the ability to raise capital, we still have to have safeguards in place and not drop all of the precautions that exist.

And one of those that I am concerned about is the change in the 404 limitations, going from $75 million, I think it is, to $500 million. Can you comment on that please?

Ms. CROSS. Certainly. I agree, first off, that our mission includes investor protection and facilitating capital formation. And if investors aren't confident in the honesty of our markets, then they won't invest, and so you haven't facilitated capital formation.

So whatever it is that happens here, whether from Congress or through the Commission, it will be important that safeguards be included, so we don't end up changing the markets to where people are afraid to go.

On 404, I would start by, of course, the opening point there is that 404(b) was enacted by Congress after the accounting scandals in Enron and WorldCom and other companies. And it did a lot to restore investor confidence and improve the quality of financial reporting. There certainly were serious concerns about the cost-effective implementation. And many steps have been taken along the way to try to enhance that.

Congress exempted 60 percent of the companies in Dodd-Frank. The move to go from $75 million to $500 million would exempt a total of approximately 80 percent. It is a pretty significant number. The Commission hasn't taken a position on the bill.

The staff did a study following Dodd-Frank, as directed by the Act, of whether there is—the staff was recommending an exemption between $75 million and $250 million. And based on looking at all the factors, the staff's recommendation was not to do that.

I think this is something that Congress should decide. It is not in the Commission's area to make this decision. If Congress were to decide to exempt additional companies, you would need to be carefully weighing the costs and the benefits and whether it should only apply to the very largest companies or the companies in this range.

One other point I would make, very quickly, is that as you go up in size on the companies, in order to decide how to do the audit, the auditors have to test internal controls to decide how much testing to do, because if they can rely on the internal control, they do less testing. So the cost as you get to bigger companies of eliminating 404(b) becomes less significant, because they are going to have to do that anyway.

Mr. PERLMUTTER. Thank you. And I guess, just in preparation for the next panel, I have a bill with Mr. Coffman from the Small Business Committee on what we call CAMS, Capital Access for Main Street.

It is on the credit side of all these, so it really isn't an SEC issue. It is more of a banking issue, which we are able to pass to make sure that community banks had appropriate capital so that they could continue to lend and make credit available to their small business customers. I hope we take that up either in the Banking Committee or here at some point.

With that, I yield back.

Chairman GARRETT. The gentleman yields back.

The gentlelady from New York?

Dr. HAYWORTH. Thank you, Mr. Chairman.

Ms. Cross, I am interested in Section 404(b) and the costs of compliance. When they were originally estimated, it was felt that the annual cost for a publicly traded company might be, on average, $91,000. But 5 years after implementation, an SEC study found that the average cost of compliance was closer to $2.37 million per company, which is obviously considerably more.

Now, it certainly can be hard to predict the cost of compliance before. We know the realities on the ground. But when we think again about how we can rationally lift burdens and yet also protect investors, you had to provide those secure markets.

Under these circumstances, given that we want to release every dollar we can for job creation for further investment and rather than tied up in red tape so to speak, would it be reasonable to propose that public companies that have no material defaults on your assessment of internal controls be allowed to go to an every other year schedule for attestations, as opposed to every year?

Ms. CROSS. That is an interesting idea. I think that the staff study looked at that question and there were concerns that may not actually save very much money, because in order to know that you are going to be okay in the following year, you would have to keep doing the work. And then the auditors are still going to be auditing the financial statements and having to decide how much they can rely on management's internal controls.

And so I am not sure that it would release a lot of savings, but it is certainly something that could be considered.

Dr. HAYWORTH. And more broadly, I guess, the question would be then, if every other year may not be a sufficient benefit, could we broaden the schedule for those who have great bona fide? Is there some way we could identify companies that are reliable doing these things?. Or can we better identify proxies for malpractice so to speak?

Ms. CROSS. Those are interesting questions. I also would like to comment on the cost. You are right that the costs were much higher than were anticipated. And I think that major efforts were undertaken, once it was realized that the costs were so high, to recalibrate through AS5 and through other work that market participants engage in.

And the costs, I understand, have come way down. But I also recognize that regulatory compliance costs are certainly a concern.

Dr. HAYWORTH. Obviously, it is one of our themes. But, I appreciate the thought that goes into that kind of issue as we go forward.

And I want to echo Chairman Garrett's thoughts on the Government Business Forum on Small Business Capital Formation. I think our small businesses eagerly await whatever forms of relief you could provide. And certainly, our office stands ready to help with bringing those forward in the form of legislation.

Thank you very much.

Ms. CROSS. Thank you.

Dr. HAYWORTH. I yield back, Mr. Chairman.

Chairman GARRETT. The gentlelady yields back.

Mr. Himes is recognized.

Mr. HIMES. Thank you, Mr. Chairman.

Ms. Cross, I have questions in two categories. The first is something you touched on in your written testimony, which is the issues raised by the definition the SEC uses around holder of record, and the fact that all of these thresholds are triggered by holder of record consideration. This has an impact on my bill and I think raises some questions.

I guess my question is, since I think the spirit of the law was not around holder of record or street name, but around beneficial holders and shareholders as individuals, over the course of thinking about this, has the SEC been provided with or do there exist good arguments in principle for why there should be a holder of record, as opposed to a beneficial holder definition?

Or are there arguments around mechanics that this would be outrageously prohibitive cost-wise for the industry to abide? And should that definition flip?

Ms. CROSS. The question of whether you should look through to the actual investors, I think is quite important. At the time when Section 12(g) was put in, most of the holders were holders of record. DTC and the street name ownership structure have developed since then.

I think that it makes a lot of sense to look through. And we are looking at that question in our study. I recognize that with regard to the community banks, they are usually holders of record. The people who are the investors are the holders of record. So the 500-holder cap hit them much harder than it does other companies who are held in street name.

I think however this is calibrated, it needs to take account of the different way companies are held. I am not sure that I—I don't have the answers today, but I am particularly sympathetic to the fact that with the community banks, they are held one-to-one, similar to the pre-IPO companies who were held one-to-one, for the most part.

Mr. HIMES. So yes, thank you. Thank you. I guess it feels to me like a historical artifact. And I guess my question, and to sort of pause it one more time is, is there a policy argument for why we use a holder of record designation as opposed to beneficial holder?

Ms. CROSS. I think that probably, if there is a policy argument today, it would be workability. I think that the question of how do you know how many holders you have, it is not hard to go to DTC and get the participant listing, which gives you a number. So if you are a public company and you need to know how many holders you have, you can do that through the DTC participant listing.

For non-public companies who are not held through DTC, it is harder certainly to see why it would be problematic.

Mr. HIMES. Okay. Thank you.

My second category of questions, in my opening statement, I said I had some concerns about the whole crowdfunding mechanism. I understand you may have a recusal issue on this, so perhaps this is for Mr. Nallengara.

Can whichever one of you is appropriate walk us through—in my understanding, your testimony indicates that Rule 504 provided a similar exemption, although I guess the threshold was $1 million rather than $5 million as proposed by the current legislation, that in 1999 there was a revision made to Rule 504 associated with investor protection.

Can you, for the benefit of the committees, walk us through the considerations that led to that revision and what the implications are for the current legislation in the 1 minute and 30 seconds we have remaining.

Mr. NALLENGARA. Yes, Congressman.

The Rule 504 consideration that resulted in the amendment related to trading in the securities—the old 504 allowed for general solicitation. It allowed for a broad sale of those securities. And because of that, there was, in some areas, fraud perpetuated in the secondary market.

As a result of that, 504 was narrowed to effectively remove in part some of the advantages that were provided in the original rule. And one of those was removing the general solicitation.

Mr. HIMES. So the fraud that led to that revision was really in secondary market trading, as opposed to fraud in initial issuance?

Mr. NALLENGARA. Primarily, it was secondary market trading. The pump and dump schemes were perpetuated using the 504 rules.

Mr. HIMES. Thank you. I yield back the balance of my time.

Chairman GARRETT. Thank you. The gentleman yields back.

Mr. Dold is recognized.

Mr. DOLD. Thank you, Mr. Chairman. I certainly appreciate the time you have allotted.

Ms. Cross, I just wanted to follow up. We talked a little bit before about costs. Obviously, small businesses' costs are a significant burden out there. We know that sometimes they are necessary.

When we look at Section 404(b), it was stated originally that the rule would impose an annual cost of about $91,000 for businesses and yet—for publicly traded companies.

But the study, 5 years later, found an average implementation cost for 404(b) to be somewhere in the vicinity of—correct me if I am wrong—about $2.87 million per company annually. Obviously, that misses the mark in terms of what people are asked to do from a publicly traded company in terms of just compliance.

So I guess my first question would be, how can this committee be assured that we don't have those types of significant errors going forward, especially when we are looking at the number of rules and regulations that are going to be coming out of Dodd-Frank and the enormous regulatory compliance costs that will be imposed?

Ms. CROSS. Thank you for your question.

First off, I guess I would say that with regard to the implementation of 404(b), we recognize that the costs were significantly higher than expected. And the rules and the implementation—the implementation rules were then changed to bring the cost down. But that doesn't make people feel better that it was very expensive at the beginning. I recognize that.

On the current—

Mr. DOLD. Can you give me an idea just of what the costs are now?

Ms. CROSS. They are in our study that is on our Web site. I can get back to you with that.

Mr. DOLD. Can you ballpark it for us? Just give me some sort of an idea, because $91,000 and $2.87 million, there is a pretty wide gap. And if it came down 50 percent, I mean—

Ms. CROSS. I believe the numbers are different at different company sizes. So I would be afraid to give you an answer that is not accurate. I think they are much lower at smaller companies, but there is a wide range.

On the question of the cost-benefit analysis at the cost of the implementation of the Dodd-Frank rules that we are currently implementing, that is something about which we are very sensitive. And we have in pre-rulemaking email boxes on our Web site where we are soliciting comment on prospective ways to implement the rules that we need to implement, we are getting comments through the rulemaking process, through the comments, so we then—through the comment request, so that we can then more accurately, hopefully, predict what it will cost.

We are seeking comment on those specific points. And if nothing else, when we implementing something that we have been directed to implement, we at least want to get good guidance from the public about how much that is going to cost, so that we can reflect that correctly in our analysis.

Mr. DOLD. Okay. Turning just for a second to Sarbanes-Oxley; does the SEC have any evidence that would point to Sarbanes-Oxley placing a disproportionate cost burden on smaller businesses?

Ms. CROSS. With the exemption of the $75 million and below level, there is no cost for relief for those companies, since they have been exempted by Congress from that.

For the next group, I think that we find that it is more expensive in comparison to your size at the smaller levels. As you go up, the costs calibrate better. But I would need get back to you with an answer for the record on all the different levels.

Mr. DOLD. The $75 million threshold, do you think that is sufficient right now? Or do you think that there is room to raise that?

Ms. CROSS. The Commission hasn't taken a position on the bills on that point. The staff study that was mandated by Dodd-Frank looked at the group from $75 million to $250 million and concluded that the staff didn't recommend an exemption at that level for a whole host of reasons, one of which included that companies move in and out of that category regularly. And so it would be difficult for even a particular company to know whether they were in or out in any given year.

But as you get larger with companies, the cost savings become less clear, because you have to test the internal controls in order to do the audit anyway.

Mr. DOLD. Sure.

Ms. CROSS. So there is some level in between, which I guess is what Congress is looking at now.

Mr. DOLD. Just my final, in the last 20 seconds, when we look at trying to leverage the Internet and the ability to try to get information out to people, and the protections that are out there, do you think that there is a way for us to be able to raise capital, to be able to safeguard without having the concern, which I recognize is very real, that people can try to raise resources on the Internet and then disappear?

But there are also a lot of secured transactions that have gone and we use the Internet each and every day. Is there a way for us to be able to leverage the Internet to try to get information out there and allow people to invest, allow small businesses to be able to reach out to people and go through a more secure process? Is that something that you are entertaining?

Ms. CROSS. Absolutely, that is something that we are looking at. We recognize the power of the outreach that you can have through the Internet. I think that possibilities include having intermediaries that are subject to oversight, so that you know that somebody is checking to see is there really a company there, and perhaps some sort of notice filings, things that might address the concerns that have been raised.

Mr. DOLD. Great. Thank you. I yield back, Mr. Chairman.

Chairman GARRETT. The gentleman yields back.

The gentleman is recognized for 5 minutes, Mr. Donnelly?

Oh, then the gentleman from New Mexico, Mr. Pearce?

Microphone. Mr. Pearce, microphone.

Mr. PEARCE. Excuse me.

Chairman GARRETT. There you go.

Mr. PEARCE. The transmission slipped out of gear. Thanks.

I know you are testifying about the capital formation. But looking at investments, protecting investors, how do you differentiate between bad business plans and fraudsters?

Ms. CROSS. We don't make that distinction on the staff. What we want is for investors to have access to the information so that they can decide if they like a particular business plan. So we try to do this through disclosure.

If some offering includes somebody with a fraud pass, for example, then perhaps disclosure would also be appropriate to get investors unnoticed, if they are dealing with people who may have a bad past.

Mr. PEARCE. Do you have any kind of a Web site to where people can come? Do you post the people that, say, repeatedly get into the fraud business? Do you have some open source? Or do they have to come and ask what about this scheme that I am seeing? What about this investment proposal that I am seeing? Do they have to ask or you provide it just—

Ms. CROSS. We don't provide investment advice at the SEC about any particular—

Mr. PEARCE. I am not asking for advice. You have people who conduct fraudulent operations and they repeat. Is that correct?

Ms. CROSS. I believe FINRA has a Web site where you can go look for information on violations by broker-dealers. With regard to information about whether any particular offering is fraudulent, if people—

Mr. PEARCE. I am not asking about a particular operation. When you have people who have established precedent, and they do fraudulent things, do you advertise for them that they are sometimes fraudulent operators, that maybe this thing they are doing isn't good? I am just asking, is it possible for investors?

One of your missions is to protect investors. And so I am asking, do you actually do things to protect investors before they get into it? Or do you only try to put out the fire after it is going?

Ms. CROSS. We try to prevent the fire through our review program, where we ask companies about their offerings and their business plans, and if we find a problem, we refer them to our enforcement division if we think there might be fraud. So our goal is to prevent fraud at the front end.

Mr. PEARCE. Yes. You were talking about the fraudsters versus investment opportunities. As you look in your daily work, looking at the combined amount of work that you do, how much is fraud and how much are probably pretty legitimate opportunities?

Ms. CROSS. Oh, I would say that, by far, my perception is that the markets are not dominated by fraud, by any stretch, that most companies are not fraudulent, are well-intentioned and provide good disclosure, and that our markets are perceived as fair and honest.

Mr. PEARCE. Does that mean less than one-half percent or less than one-tenth or one percent? Or do you have any quantitative data on that about basically how many—if people are looking on the Internet, they can assume that one-tenth or one percent is fraudulent. You don't quantify it or you do?

Ms. CROSS. I don't have statistics like that. I do know that we have an Internet fraud task force that searches the Internet to look for fraudulent offerings. And I think those actually find a pretty significant amount of them. But there are plenty of other, obviously, non-fraudulent investment opportunities.

But it is an area that does present the ability to come in, steal money, and disappear. So it is always a cost-benefit analysis. You don't want to regulate to the absolute, zero fraud risk, but you also want to be in the place where you can protect investors at a reasonable level.

Mr. PEARCE. As you evaluate the capital formation in the last 5 years, is capital formation increasing, decreasing? What is happening in the big picture?

Ms. CROSS. My understanding is that the IPO markets have been coming back, which is a positive sign, although the markets themselves are rocky, so that is hard to calibrate.

For the smaller companies, I think it has been challenging. I think the financial crisis cut off a lot of capital. And so it has taken time for the capital markets to come back. But we have seen signs of increasing offering activity, at least in my division.

Mr. PEARCE. Okay. Thank you, Mr. Chairman.

Chairman GARRETT. And I thank the gentleman.

And Mr. Stivers is recognized.

Mr. STIVERS. Thank you, Mr. Chairman.

Ms. Cross, thank you for being here. Your Regulation 12(g), which was passed in 1964, I guess issued in 1964, originally held small companies, including community banks, to a $1 million asset threshold and 500 shareholders. I wanted to just give you a story and help me as we go through it.

In 1964, my father was 29 years old. He bought shares in the community bank. Unfortunately, my father passed away in 2004 at the age of 69 years old. He had three children. And I am one of them.

So can you tell me basically what happened to the holders of record probably, since we all got equal shares? They went up by three.

In a generation, if people, let us say, on average, have 2 kids, and a bank starts out at 280 shareholders, after a generation, assuming that they issue no stock, what is going to happen to the number of shareholders of record?

Ms. CROSS. I guess, you have to know how many children are, but—

Mr. STIVERS. I said, on average, they have two children so—

Ms. CROSS. So it will double. Right.

Mr. STIVERS. They will go over what number? 500?

Ms. CROSS. Correct.

Mr. STIVERS. And so in that 40 years, you increase your asset threshold by 10 times and you increase the number of shareholders by how many, in rule?

Ms. CROSS. It has stayed the same.

Mr. STIVERS. Zero, that is right. And so, I guess I want to urge you—I appreciate the bills on this with Mr. Schweikert, Mr. Himes, and others. But it doesn't take a bill. This is a rule.

You have increased the asset number over 40 years. You could today, and I wish you would go back and do this, increase the number of shareholders today, because community banks are getting especially hammered by this.

I talked to a community banker this weekend. And he told me that they did a reverse three to one split just to try to prevent having—or to deregister. And when you deregister, actually you don't go to 499. You have to go to 300.

That is the other thing I would tell you. If there is a line, there is a line. And the deregistration number should be the same as the registration number, in my opinion. So if you go below 499, you can deregister. And so I would ask you to look at that as well. These are things that don't take our action.

And, since the United States Senate has passed five substantive bills this year, and these bills are great, but they are probably not going to happen. So you have the ability to relieve regulatory burden on banks, and I am asking you to do it.

Ms. CROSS. I appreciate your—

Mr. STIVERS. I guess that is not a question, but I will take your response.

Ms. CROSS. I know. Thank you. I appreciate the concern. And it is something that we understand needs attention right away.

Mr. STIVERS. Great. And I think maybe I finished the story. So when he did his reverse three to one split, deregistered, went below 300 shareholders, he was earning about a million dollars a year and he saved $200,000. That is 20 percent. That is meaningful.

And so I would ask you to—I don't really have a lot of other questions. I guess the only other question I have, because you did get into a conversation about a street name, but if you don't issue securities in 30 years, like a lot of these community banks have shareholders, and they haven't been actively issuing securities, they don't really have a market maker.

So these stocks aren't in DTC. They are in manual form. And they have the shareholder's name on it. And it disproportionately affects those folks. So—

Ms. CROSS. I appreciate that, yes.

Mr. STIVERS. I would be happy to yield the rest of my time to Mr. McHenry. But again, before I yield my time, I would urge you to go back and get to work. We need your help. These community banks that are struggling need your help.

Ms. CROSS. Thank you.

Mr. STIVERS. Thank you.

Mr. MCHENRY. Thank you, all. Thanks for your testimony today. I thank my colleague for yielding.

Ms. Cross, I certainly understand your recusal and I respect that. Thank you for taking that action.

So, Mr. Nallengara, thank you for being here. You mentioned under the old Rule 504 that the change was on general solicitation—remove that change. You said the fraud occurred in the secondary market trading. Is that correct?

Mr. NALLENGARA. Yes, primarily.

Mr. MCHENRY. Primarily. How many prosecutions came as a result of that fraud?

Mr. NALLENGARA. I don't have that information. I think we can—

Mr. MCHENRY. If you would come back to us with that, submit that in writing, that would be helpful for us to understand. And if the real concern is the secondary market, not the direct issuance, was there much fraud in the direct issuance?

Mr. NALLENGARA. Again, I would need to gather that information.

Mr. MCHENRY. Okay. Thank you. I yield back.

Chairman GARRETT. And I thank the gentleman for yielding back.

The gentleman was not using his time during that time, but does the gentleman have any other questions?

Mr. MCHENRY. I yield back.

Chairman GARRETT. You yield back? I understand.

But now it is time for your time. Did you have additional questions?

Mr. MCHENRY. [Off mike.].

Chairman GARRETT. Very good. We will see during the 5 minutes whether it is very good or not.

Mr. MCHENRY. Thank you. Thank you, Mr. Chairman. Thank you for your generosity.

Chairman GARRETT. We are raising the bar as it is—but we know we will always—

Mr. MCHENRY. That is a short choke. I will take that, Mr. Chairman. So—

Chairman GARRETT. No, no, no.

Mr. MCHENRY. —with that, I appreciate—

Chairman GARRETT. We don't all see things through those glasses.

[laughter]

Mr. MCHENRY. And you have just used up 15 seconds. Thank you and thank you for your testimony.

Mr. Nallengara, very simple questions. Obviously, we are concerned about fraud. Mr. Himes has some very solid questions about fraud. But, was it general solicitation that really allowed the perpetration of fraud?

Mr. NALLENGARA. In part, it was also the fact that the securities were not restricted securities. So upon issuance, those securities were freely tradable.

A consideration would be whether in any capital-raising strategy that would be designed to assist small business, you would consider whether the securities issue, if you place transfer restrictions on them, that could prevent some fraud in the after-market trading.

Mr. MCHENRY. Okay. So perhaps by a limitation of information and a limitation of capital that can flow into these transactions, that allowed for a greater avenue of fraud, because there is less information and less capital flow.

Mr. NALLENGARA. Sorry, Mr. Chairman, I am not sure I—

Mr. MCHENRY. Okay. What I mean is with less information available on a security, as a purchaser, it gives you less avenue to understand what you are actually purchasing. Is that correct?

Mr. NALLENGARA. Yes.

Mr. MCHENRY. Okay. So, this is sort of the sticky wicket on the subject matter, because many of my colleagues, they will make it sound like the fact that you are making these decisions over the Internet and capital is flowing over the Internet—it makes it sound like the Internet is the great perpetrator of fraud.

And I said this to Ms. Cross in our hearing last week, that it sounds like the SEC's mentality is that eBay couldn't exist because there would be this fraud perpetrated on a mass basis. But, I would dissuade you from that type of thinking.

So the real question here is, how do we allow average investors to help access capital for startups. Is that possible?

Mr. NALLENGARA. Mr. Chairman, I think it is possible. And part of the discussion is looking at how to harness the technology and the power of social media to provide an opportunity for small businesses to seek capital from a broader scope of investors and a geographically dispersed group of investors.

Mr. MCHENRY. Okay. So what if you had—obviously, broker-dealers are important in this process in securities trades. What if you had a small broker-dealer exemption, small issuance for broker-dealer? In essence, for smaller issuances, you have a lower regulatory hurdle. Is that something the SEC is looking at in order to spur crowdfunding.

Mr. NALLENGARA. The Commission hasn't taken a position on—

Mr. MCHENRY. No, at the staff level, has that been discussed?

Mr. NALLENGARA. At the staff level, we have considered a variety of different investor protection possibilities in crafting an exemption for crowdfunding.

One of those would be providing some oversight of the intermediaries at the broker-dealer, for lack of a better term, the individuals or the Web site that is facilitating the transaction between the small business and the investor, yes.

Mr. MCHENRY. Okay. So, in essence, regulate that marketplace where this would be done.

Mr. NALLENGARA. Correct.

Mr. MCHENRY. Correct. Okay. Now, and I understand the difficulty here that you are sort of answering these questions that I have had a great conversation with Ms. Cross about in the discussions you all have had.

But, in essence, you regulate that marketplace and you have basically the rules of the road, so you can have these transactions, rather than regulate all the issuers, basically the small businesses.

Maybe they were trying to raise a half a million dollars or $100,000. Do you regulate that playing field? Is that sort of the mentality of the SEC on how this could work?

Mr. NALLENGARA. I wouldn't characterize that as being the mentality of the SEC. I think that is one of the considerations that we are looking at when we analyze crowdfunding. When we look at the benefits that could be derived from small business capital formation and we try to calibrate that with providing the appropriate level of investor protections, we see one of the ways to do that would be through looking at intermediaries and providing some oversight over their activities.

Mr. MCHENRY. Thank you.

Chairman GARRETT. I thank the gentleman. And I thank this panel. I thank the gentleman. I believe we all agree by unanimous consent the gentleman has met the bar and exceeded it. He raised up to that threshold. So I appreciate the gentleman's questions.

And again to this panel, I very much thank you very much for this panel. And you are dismissed.

Will the second panel please come forward?

You all can be seated, yes. Get comfortable. You are going to be here for hours and hours—

Oh, I am told that when I say things like that, you believe me. So, no, you are not going to be here for hours and hours.

I thank the second panel for being with us today. And as indicated before, as you all know, your complete written statements will be made a part of the record. You will be recognized for 5 minutes.

And we will begin with Mr. Abshure.

STATEMENT OF HEATH ABSHURE, ARKANSAS SECURITIES COMMISSIONER, ON BEHALF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC. (NASAA)

Mr. ABSHURE. Good morning, Chairman Garrett, Ranking Member Waters, and members of the subcommittee. I am Heath Abshure, Arkansas Securities Commissioner and chairman of the Corporation Finance Section of the North American Securities Administrators Association, or NASAA.

NASAA is the association of State and provincial securities regulators. I have a keen interest in issues regarding capital formation. And I was pleased to accept an appointment on September 13th as an observer member of the SEC's Advisory Committee on Small and Emerging Companies.

State securities regulators are acutely aware of the difficult economic environment and its effect on job growth. In Arkansas, I see the recession's impact on small businesses every day.

I can assure the subcommittee that no State securities regulator wants to inhibit America's economic recovery by regulation that is overly burdensome or restrictive. We do have serious concerns about recent proposals put forth in Congress that proposed to spur job growth by rolling back investor protections or preempting State investor protection laws.

Unfortunately, this is precisely the approach that is taken by some of the bills that are the focus of the hearing today.

Increasing small businesses' access to investment capital has the potential to be a very positive economic force and a major driver of wealth and jobs. At the same time, if done irresponsibly or hastily, such policy changes have the potential to become costly failures that undermine market disciplines and place Main Street investors at great risk.

This last point is crucial because investors must be confident that they are protected in order to be confident enough to invest capital in the markets that Congress seeks to grow. The stakes are high in this area because while many don't recognize or acknowledge it, small businesses investments are extremely speculative.

Proponents of the legislation under consideration today tout the high rates return sometimes associated with small business investment. However, in a majority of cases, these high returns are not realized. Unfortunately, roughly 50 percent of small businesses fail within the first 5 years

The risks associated with small business investment arise from a host of factors. In my experience, these risks include the fact that small business investments are almost entirely illiquid and often rely for success on unproven technologies, business models, market assumptions, and other unknowable factors.

The important point is that this is a risky area, and not an area where Congress can expect that investor protections can be withdrawn without average investors getting hurt.

Efforts to foster capital growth for small business must consider and address the particular dangers investors will encounter. I am very concerned that some of the proposals being contemplated include substantial preemptions of State authority.

State authority to continue to review and police investments must be preserved. Any capital formation proposal should consider carefully the loss of investor protections that a partial or complete preemption of State regulation would cause.

As we saw with the passage of the National Securities Markets Improvement Act in 1996, State securities regulators have been handcuffed from reviewing certain offerings prior to sale. Since then, a regulatory black hole has emerged to expose investors to high-risk investments offered by companies with little or no financial stability or regulatory scrutiny.

In the 15 years since NSMIA became law, it has become painfully clear that preemption of State review of offerings is a failed experiment. We must not let history repeat itself by creating more regulatory black holes and exposing investors to unacceptable levels of risk and fraud.

Let me now comment on the legislation before the subcommittee.

The Entrepreneur Access to Capital Act, H.R. 2930, seeks to create a new exemption from registration for security offering, commonly known as crowdfunding. Crowdfunding may sound like a good idea and enjoy a measure of bipartisan support. But on careful inspection, it is apparent that the crowdfunding exemption contemplated by H.R. 2930 is replete with problems.

Section 4 of H.R. 2930 specifically preempts State law for the new crowdfunding exemption. We strongly oppose this provision. States have been vigilant in protecting retail investors from the risk associated with these securities. State authority to continue to review and police these investments must be preserved.

Further, if crowdfunding centers around community investment, the oversight must be vested with the regulator with the most direct interest in protecting that community, and that is the States.

Additionally, under the current proposal, there will be no verification that the issuing companies actually exist. With no notice, there is no ability for a State to be certain that the issuer is really a business entity or even really has an address.

Further, there is no disqualification provision so that bad actors can't use it. This is going to result in an enforcement nightmare.

The Access to Capital for Job Creators Act, H.R. 2940, will allow general solicitation in Rule 506 offerings. I have already noted the States' experience with 506 offerings after NSMIA preempted State regulation.

As the subcommittee is aware, Rule 506 is a safe harbor under Section 4(2) of the Securities Act of 1933. These securities were meant to be private offerings. With its expansion, we are getting further and further away from the ideas of a private offering under Section 4(2). There is nothing private left.

An issuer can advertise to an unlimited number of people, raise an unlimited amount of money, and sell to an unlimited number of accredited investors without filing a single disclosure document. And there is no presale review of any document by any regulator.

This is clearly a nonregistered public offering, which is not allowed under the exemption of 4(2).

Further, I see it firsthand. Privately placed securities, including Rule 506 offerings, are the biggest enforcement issue in Arkansas and throughout the country. They did it—sir?

Chairman GARRETT. You are 1 minute over actually. But—

Mr. ABSHURE. I will get to my conclusion, I will wrap it up.

Chairman GARRETT. I have been enjoying hearing your points, but if you can wrap it up, yes.

Mr. ABSHURE. They have been identified by State regulators as the top 10 investor trap in three of the last 5 years. Given the potential amount of fraud investor losses, NASAA has significant concerns about H.R. 2940 and believes there is a more reasonable way of doing this, as I have discussed extensively in my written testimony.

In conclusion, State regulators understand the complex challenges faced by small business issuers. We also understand that a reasonable balance of the issuers' interests and the investors' interest is in the best interest of both groups. The States are ready to play an active role in balancing those two interests.

Thank you, and I will be happy to answer any questions.

[The prepared statement of Mr. Abshure can be found on page 54 of the appendix.]

Chairman GARRETT. Thank you.

Ms. Mauriello?

STATEMENT OF DANA MAURIELLO, CO-FOUNDER AND PRESIDENT, PROFOUNDER

Ms. MAURIELLO. Good morning. My name is Dana Mauriello, and I am a co-founder and president of ProFounder, which is an online platform for raising investment capital from your community. We do this through—first, I apologize for forgetting to thank you so much, Chairman Garrett, for having me here, and members of the subcommittee.

We do this fundraising through Regulation D 504, securities exemption for private offerings within communities. And we take no salesman stake in those deals. I am here to comment specifically on H.R. 2930, as that is my area of expertise and experience.

We started ProFounder because we saw a very interesting case study unfolding around us. We saw our classmates wanting to raise capital from fellow classmates, the people who knew them best. And we saw them not being able to do so because our classmates were "unaccredited investors," a term that we weren't even familiar with before the lawyer made us aware that this capital could not be freely traded in these communities.

That really confused us, how you could have entrepreneurs doing great things, communities that want to support them, and yet, for some reason, those two parties could not connect. So we embarked on an effort to find a solution via ProFounder for communities to be able to support each other in a very efficient, simple, inexpensive way.

This seems like second nature to be coming from small family businesses, none of which would have gotten off the ground without supportive aunts, uncles, family members, and friends, doing exactly the same thing that our classmates were trying to do.

Since then, we have helped—since starting ProFounder, we have helped a number of entrepreneurs. I will highlight one, Bronson Chang. He has a shaved ice stand in Honolulu, which he was able to start with $54,000 that he raised through ProFounder with the help of 19 investors. Those 19 investors included his college roommate, his best customers, his aunts and uncles, etc.

Through this venture, he has created six jobs. He employed a construction company for 3 months to open his new shop. We are so proud of him and other stories.

We have so much more potential through the help of H.R. 2930 to help other entrepreneurs like Bronson.

I am very pleased with what Mr. McHenry has put forward. And I would like to suggest two more pillars be added to this for discussion. One is how the platforms that facilitate crowdfunding can be able to succeed. As great as the bill is, the platforms also need to be able to help make this happen for it to be taken advantage of.

And second and very importantly, investor protection. I certainly echo that concern.

So first, on the topic of how these platforms can succeed and facilitate, one is national preemption. The current regime of State regulation makes it extremely difficult to scale the model of crowdfunding, how this can happen. The majority of our deals that we have done have had investors from about three States.

Negotiating the laws between those three States to allow for these issues to happen in an efficient, scalable way is extremely challenging. For example, if I have one investor from the State of Colorado, under 504, I can only have 10 investors from the State of Colorado. Rules like that made it extremely difficult to scale.

If I want to have my aunt in New York invest in my company, I need to pre-file and get approval from the State of New York in writing, which will take a few weeks, if not months, to get before my aunt can invest in my company. These are some examples of why I think scalability through national exemption is important.

Second, broker-dealer licensing. I was told by a broker-dealer yesterday that it takes them $25,000 minimum to do the due diligence necessary for them to facilitate deals. The average deals that we do are $30,000. It is a completely cost-prohibitive process to abide by current broker-dealer processes for these rules. I am in support of mini broker-dealers or other ways to make this flexible for smaller offerings.

Now, to highlight investor protection. Certainly, I think this is important. I think one of the ways that it can be done, among many, is through qualifying purchasers. The way that general solicitation can be effective is as a way to spread the word to your community in a free way about what is happening. But then there is no reason that the people who actually can invest after learning about the opportunity don't need to be qualified, qualified through sophistication.

A definition is needed for what sophistication truly means, to allow people to make those investments. Through knowing the issuer, or through being local, being physically co-located next to the coffee shop makes you very qualified to evaluate opportunities, to gather information, to learn about the issuer and be able to invest.

Next, I have been inspired by what FINRA has done with self-regulation. I think that we have a lot, as a crowdfunding industry, to learn and can replicate and add on to what FINRA has created as a self-regulatory body.

For example, one thing that I think that this self-regulatory body would put in place is no endorsements on behalf of non-broker-dealers. So to go back to the pump and dump schemes, which were mentioned before, the problem with 504 when it happened in the late 1990s, in addition to secondary markets, the real problem was also broker-dealers were making cold calls and hard selling to purchasers who didn't have adequate information. So that is where regulation can happen.

If I am an open marketplace that is not endorsing deals, not pushing deals, not doing what happened into the late 1990s, then that regulation should not apply to me. If I do want to do that endorsement, sure, there is a different level of regulation that can be necessary.

Thank you so much for the time. And I look forward to your questions.

[The prepared statement of Ms. Mauriello can be found on page 85 of the appendix.]

Chairman GARRETT. Thank you very much.

Mr. Molinari, you are recognized for 5 minutes.

STATEMENT OF VINCENT R. MOLINARI, CO-FOUNDER AND CHIEF EXECUTIVE OFFICER, GATE TECHNOLOGIES, LLC

Mr. MOLINARI. Chairman Garrett, Ranking Member Waters, and members of the Subcommittee on Capital Markets and Government Sponsored Enterprises, my name is Vincent Molinari. I am the chief executive officer and co-founder of GATE Technologies, LLC.

I commend the chairman, the ranking member, and the members of the subcommittee for holding this hearing on the proposals that facilitate small business capital formation and job creation.

I also want to acknowledge Chairman Bachus and Ranking Member Frank and thank them for bringing these issues before the public today. I offer my opinions today as a businessman, an entrepreneur, and a chief executive of a firm committed to the creation of new jobs through innovation and capital formation.

GATE is a global financial services and technology company, which I co-founded in 2009. We provide technology solutions and develop platforms that facilitate the trading of illiquid securities and promote transparency. Currently, GATE operates in the United States though its wholly owned broker-dealer subsidiary, which is registered with the SEC and FINRA as an alternative trading system. GATE also operates a subsidiary, which focuses on impact investing.

We facilitate transactions in the following asset classes: unregistered securities of private companies; restricted securities of publicly traded companies; and warrants. GATE is also working with other firms to facilitate the trading of State and Federal tax credits, asset-backed securities, and limited partnerships.

We believing in creating value through trading in structured, regulated venues, where buyers and sellers meet for price discovery and to transact, settle, and transfer securities.

Our business is fully regulated, archivable, and auditable. While the core of our business model is creating value for private companies and market participants, GATE itself is also an innovative, privately held, emerging company.

GATE appreciates the role of the SEC in protecting the public and preserving market integrity. We believe the trading of unregistered securities is accomplished most effectively through a broker-dealer, an ATS, or an exchange registered with the SEC, because such transactions provide the books and records and the audit trail that can be used for surveillance processes.

While the SEC has the authority to amend Regulation D and Regulation A, we support the legislation design to amend both of these regulations.

The capital formation process is currently broken. And the proposed reform of Regulation D would be a welcome improvement. The proposed changes would promote economic expansion and job creation.

I commend Representative Schweikert on the bill's introduction, which would increase the total asset threshold for registration to $10 million and raise the shareholder of record limitation from 500 to 1,000 holders.

Increasing the SEC's Regulation A exemption from $5 million to $50 million will improve the ability of small companies to access desperately needed capital.

By reducing the regulatory burden and the expenses associated with capital from the investing public, Congress can boost the flow of capital to small businesses and fuel America's most vigorous job-creation machine.

I commend Representative Schweikert, as well as the Financial Services Committee for considering and passing this legislation in June. I look forward to the House Floor action on the legislation, and I also commend the authors of the Senate companion, Senators Tester and Toomey.

Crowdfunding: GATE is encouraged by the Entrepreneur Access to Capital Act sponsored by Congressman McHenry and President Obama's support for crowdfunding initiatives.

Any efforts that promote capital formation at the microfinance level have an immediate positive effect on capital formation and job creation. GATE is prepared to facilitate such efforts through our GATE Impact Platform and is confident that other firms will also rise to the call in assisting in this effort.

I am encouraged by the recent progress that has been made. I commend President Obama and Speaker Boehner for their leadership on this issue.

I congratulate the authors and co-sponsors of the pending legislation, as well as the leadership of the relevant committees on both sides, as we are moving forward with continued discussions, hearings, and some mark-ups.

When companies have adequate capital, they can invest, expand, and hire. These small and private companies offer the economy tremendous growth potential and job creation. And they deserve to be supported with Federal policies that make capital more available and foster their success.

They have the ability to become the engine of economic recovery, which is so sorely needed in the United States today.

On behalf of GATE Technologies, thank you for the opportunity to present these views in support of reforming the capital formation process.

[The prepared statement of Mr. Molinari can be found on page 100 of the appendix.]

Chairman GARRETT. And I thank you.

And the founder of SecondMarket, Mr. Silbert, you are recognized.

STATEMENT OF BARRY E. SILBERT, FOUNDER AND CHIEF EXECUTIVE OFFICER, SECONDMARKET

Mr. SILBERT. Thank you.

Good morning, Chairman Garrett, Ranking Member Waters, and members of the subcommittee. My name is Barry Silbert, and I am the founder and CEO of SecondMarket. I am grateful for the opportunity to testify this morning regarding these very important topics.

I founded SecondMarket in 2004 to create a transparent, centralized and independent market for alternative investments, including stock in private companies. We have grown rapidly and now employ nearly 150 employees in New York and California. And we completed several billions of dollars in transactions. We are a FINRA-registered broker-dealer and an SEC-registered alternative trading system.

Up until a decade ago, fast-growing startups followed a similar capital formation path. They raised angel capital, a few rounds of venture capital, and went public in about 5 years. For several decades, these small-cap companies could thrive in the public markets with research coverage, brokers, and market makers driving investor interest in these companies.

The public market allowed companies like Starbucks, Intel, Genentech, and Dell to grow from small-cap companies into economic powerhouses. However, the capital formation process has evolved over the past decade, and the public markets are no longer receptive to small companies. It now takes companies twice as long, nearly 10 years, to grow large enough to reach the public market.

A number of factors have contributed to the systemic problems in the public stock market. These include a shift from stockbrokers to online trading, the inability for market makers to profit from supporting small-cap stocks, lack of research coverage on smaller companies, and finally, Sarbanes-Oxley, which made it cost prohibitive to be a small public company.

One other important systemic change is the emergence of computer-driven high-frequency trading. Although it brings liquidities to public markets, these traders ignore small-cap companies and have contributed to the casino-like trading atmosphere in the markets.

Disturbingly, it is estimated that over 60 percent of public stock market trading volume is being done by computer algorithms, which has caused the average time that a share of public stock is held to decline from 5 years in 1970 to less than 3 months today.

The small-cap market is a vital part of the capital formation process, and the failure of U.S. capital markets to support these companies limits our ability to create jobs, innovate, and grow. In fact, in 2010, a Kauffman Foundation study noted that without startups, there would be no net job growth in the U.S. economy. It is essentially that the regulatory framework recognizes this reality and enables these startups to flourish.

Thus, I believe there are two regulatory hurdles in particular that must be re-examined. The first is the so-called 500-shareholder rule. As you know, pay structure at startup companies generally involves giving employees below-market salaries, coupled with stock options. These options enable employees to realize the financial upside, while enabling the startup to higher top talent even if they don't have the cash to pay market salaries.

As a result, this cap has created a disincentive for private companies to hire new employees, raise capital from a broad group of investors, or acquire other businesses for stock, as the companies are fearful of taking on too many shareholders and, thus, triggering a public filing requirement.

That is why I strongly urge Congress to pass H.R. 2167, the Private Company Flexibility and Growth Act, which increases the shareholder threshold from 500 to 1,000, while also exempting employee owners and accredited investors from the count.

The second rule that must be re-examined is the prohibition against general solicitation, which requires that issuers have a pre-existing relationship with the investor prior to making an offering available. Given that only accredited investors are eligible to purchase private company stock, we should strive to maximize the full investors that are aware of an offering. In short, let everyone see, but only let accredited investors invest.

Thus, I urge the passage of H.R. 2940, the Access to Capital for Job Creators Act, which eliminates the ban against general solicitation, provided that the ultimate purchaser qualifies as an accredited investor.

Although I do not have the expertise to provide detailed feedback on the other bills under consideration, I fully support the contemplated policy changes to create an exemption for crowdfunding, to allow private community banks to have 2,000 shareholders, and to ease the compliance requirements of Sarbanes-Oxley.

Additionally, I support the legislation put forth by Representative Schweikert and endorsed by the President to increase the cap on many offerings under Reg A from $5 million to $50 million.

In summary, it is absolutely critical that we address our data and regulatory framework around capital formation. Without these rule changes, we will significantly limit access to capital for our young, small companies, thereby restricting job growth, stifling innovation, and weakening the United States globally.

Thank you again for the opportunity to participate this morning.

[The prepared statement of Mr. Silbert can be found on page 110 of the appendix.]

Chairman GARRETT. Thank you.

Mr. Waddill, senior vice president and chief financial officer of—is it OncoMed?

Mr. WADDILL. Yes.

STATEMENT OF WILLIAM D. WADDILL, SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, ONCOMED PHARMACEUTICALS, INC., ON BEHALF OF THE BIOTECHNOLOGY INDUSTRY ORGANIZATION (BIO)

Mr. WADDILL. Good morning, Mr. Chairman, and members of the subcommittee. Thank you for giving me the time to speak today.

My name is William Waddill. I am senior vice president and chief financial officer of OncoMed Pharmaceuticals, and co-chair of the Finance and Tax Committee at the Biotechnology Industry Organization. I want to thank you for the opportunity to speak with you today about the unique hurdles that innovative biotechnology companies face.

Biotechnology has incredible potential to unlock the secrets to cure a devastating disease and help people live longer, healthier, and more productive lives. But the barriers that small biotech companies encounter on a daily basis raise some important questions.

Would we rather see the next generation of breakthrough cures discovered by researchers in New Jersey or New Delhi? Do we want the jobs associated with these groundbreaking science to go to workers in San Francisco or Shanghai?

If we want more scientific breakthroughs that allow us to enjoy a high quality of life, indeed, breakthroughs that save the lives of our loved ones, then shouldn't we put in place policies that encourage innovation?

While the biotechnology industry faces significant challenges, we nonetheless have the ability to deliver the next generation of cures and treatments to the bedsides of patients who desperately need them, while, at the same time, creating a healthier American economy.

The leash that holds our industry back from helping more people, in a large part, is the exorbitant costs of development of treatments that must be undertaken by a growing company. Today, Congress has the opportunity to help speed lifesaving cures and treatments to patients by removing burdens to innovation in our industry.

As you know, the Sarbanes-Oxley Act was passed in 2002 with the intent of protecting investors from corporate fraud. While we can all agree that investors benefit from the greater transparency, some of the regulations found in SOX, namely Section 404(b), are unnecessarily burdensome on small companies, and often involve onerous compliance with little to no benefit to investors or the general public.

In fact, the biotech companies facing their first few years as a public company are forced to divert funds from scientific research and development to the stringent Section 404(b) auditing requirements. The opportunity cost of this compliance can prove damaging, resulting in limited resources being driven away from a company's research for cures and treatments.

The compliance costs of Sarbanes-Oxley are fixed and ongoing, and have a severe impact on the long-term investing of microcap and small cap companies at the forefront of developing new treatments for severe diseases.

These small companies are the most affected by SOX at a time when they often have little or no product revenue to devote to compliance costs and must, as a result, shift funds from core research functions. This can lead to research programs being shelved or slowed as compliance takes precedence.

Further, the true value of a biotech company is found in scientific milestones and clinical trial advancements towards FDA approvals, rather than financial disclosures of losses incurred during protracted development terms. Investors often make decisions based on these development milestones rather than the financial statements mandated by Section 404(b).

Thus, the financial statements required do not provide much insight for potential investors, meaning that the high costs of compliance far outweigh its benefits.

The Dodd-Frank Act set a permanent exemption from Section 404(b) for companies with a public float below $75 million. However, the SEC Small Business Advisory Board recommended in 2006 that the permanent exemption be extended to companies with public floats less than $700 million.

The Advisory Board also realized that public float alone does not fully portray the complexity and risk associated with a reporting company, and suggested a revenue test to paint a more fuller picture. Revenue should be a critical consideration when determining the appropriateness of Section 404(b) compliance, along with public float.

Public companies with a public float below $700 million and with product revenue below $100 million should be permanently exempt from Section 404(b), allowing them to focus their resources on critical research and development rather than burdensome regulations.

The U.S. biotechnology industry remains committed to developing a healthier American economy, creating high-quality jobs in every State, and improving the lives of all Americans.

In my written testimony, I have detailed a number of additional provisions which could bolster capital formation to make these advances possible. There are many pitfalls and obstacles endemic to biotechnology, including scientific uncertainties and the high costs of conducting research.

However, the challenge added by Sarbanes-Oxley continues to stand in our way without providing a real benefit to the investors the law purports to protect.

Congress has the opportunity to support and inspire biotechnology breakthroughs by unburdening startup companies and allowing innovation and entrepreneurs to continue working towards delivering the next generation of medical breakthroughs and, one day, the cures to patients who need them.

Thank you.

[The prepared statement of Mr. Waddill can be found on page 127 of the appendix.]

Chairman GARRETT. Thank you, Mr. Waddill.

Mr. Williams, chairman and president of—is it Gothenburg State Bank?

Mr. WILLIAMS. Yes.

Chairman GARRETT. On behalf of the American Bankers Association.

STATEMENT OF MATTHEW H. WILLIAMS, CHAIRMAN AND PRESIDENT, GOTHENBURG STATE BANK, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION (ABA)

Mr. WILLIAMS. Mr. Chairman and subcommittee members, my name is Matt Williams, and I am president and chairman of the board of the Gothenburg State Bank in Gothenburg, Nebraska. I am pleased to be here today to represent the ABA. And I also appreciate the chairman's remarks when he started this committee meeting today talking about building companies and creating jobs. That is what banking is about in our country.

The topic of this hearing today is an important one for a great many community banks whose shareholders include generations of families and local community members.

Many of these community banks have faced a rule that has remained in place for over 40 years without being updated. That rule, under the Securities Exchange Act of 1934, causes small, local banks to be subject to the same costly reporting requirements as large public firms.

The Exchange Act has two tests to determine whether a company must register its securities with the SEC. The first test is the $10 million asset test. The loans that we, as banks, make are considered assets, so this measure is actually meaningless. There are more than 7,500 banks in our country, but only 31 of those banks are less than $10 million in total assets.

The second test is the limit of 500 shareholders of record. This is the only test that really matters for banks. While the asset threshold has been increased tenfold since the tests were introduced in 1964, the shareholder test has stayed the same. It is time to update this threshold.

In my role as vice-chairman of the American Bankers Association, I have the opportunity to speak with bankers all across the country. One banker recently explained to me how a small institution found itself in a situation where it was going to have to register with the SEC.

This bank had, for many years, offered shares to community members. These shareholders distributed stock to children, to grandchildren, multiplying the number of shares outstanding.

When this bank reaches its 501st shareholder, it is either going to have to reduce the number of shareholders or become subject to the full range of regulatory requirements that apply to the largest of public companies. This makes no sense and absorbs precious resources that could better be put to use by small banks making loans.

Not surprisingly, when the economy is weak, new sources of capital are scarce. This is made more serious by bank regulators piling on new requests for even greater levels of capital.

Existing shareholders may not be willing or able to invest additional capital in small banks. Banks that are nearing the 500-shareholder threshold cannot access new capital from additional investors without registering as a public company and incurring those significant costs.

To boost their capital-to-asset ratio to satisfy regulatory demands, these banks are forced to shrink by making fewer loans in order to raise their capital past that ratio. Clearly, it would be better to turn to additional investors to provide new capital that would support additional community lending.

We are grateful, Vice Chairman Schweikert, to you and to Representatives Himes and Womack for introducing legislative solutions. These bills would increase the shareholder threshold for registration to as many as 2,000 shareholders, a level the ABA supports for banks, and allow the SEC to provide much needed regulatory relief for community banks.

ABA also recommends raising the threshold for deregistration. Raising the 700-shareholder cap would eliminate costly reporting requirements that are unnecessary for small banks that are already highly regulated and have significant reporting requirements. It would increase access to capital and free up resources that could be better used making loans.

The urgency to address this situation increases everyday. Over the last several years, banks have faced increased regulatory costs and will face hundreds of new regulations with the Dodd-Frank Act.

These pressures are slowly but surely strangling the traditional community banks, and handicapping their ability to meet the credit needs of their communities. Increasing the shareholder limit would open up an avenue to bring capital to community banks.

The ABA stands ready to work with this subcommittee to move this important legislation forward. I look forward to answering your questions.

[The prepared statement of Mr. Williams can be found on page 133 of the appendix.]

Chairman GARRETT. Thank you, Mr. Williams.

All right. Let us do the first question with my good from Frog Jump, Mr. Fincher.

Mr. FINCHER. Thank you, Mr. Chairman.

Thank you, guys for your testimony. It was great.

Just to Mr. Waddill, a question for you, the limit of 404(b). On average, how many research and development jobs—because that is what we are focused on now is opening up the flow of capital to the private sector, which would make it easier for us to recover from this recession and downturn that we have been in for a while.

But how many jobs are not realized due to the dollar cost of 404(b) compliance for a small company with a market cap of, say, $150 million?

Mr. WADDILL. Right. So if I may be allowed to jump on the theme of math that has been presented recently, for every million dollars that I have to pay to an auditing firm, I am going to be prohibited, just because of allocation of funds, to hire 10 to 15 employees.

So if you look at some of the averages that were in the SEC report that can be multiplied twofold or threefold, depending upon my compliance cost and having to spend money there versus hiring people.

Mr. FINCHER. Thank you. I yield back, Mr. Chairman.

Chairman GARRETT. You are making my life far too simple.

Mr. FINCHER. Thank you.

Chairman GARRETT. The gentlewoman from New York is recognized.

Mrs. MALONEY. I thank all of the panelists for what you are doing to help our economy, out there employing people and going to work on it, and looking at ways that we can grow our capital and liquidity in the markets.

I want to welcome one of my constituents, Barry Silbert, who is the founder and CEO of SecondMarket. And he was also honored by the World Economic Forum as a technology pioneer and was recognized by Fast Company as one of the 10 most innovative companies in finance.

So congratulations to you. I single you out only because you have a company in the district that I am honored to represent. But I believe all of you have done innovative, exciting efforts to grow our economy.

And we are right on message. The President's most recent speech focused on ways to bring more liquidity to our capital markets and to help finance.

We have two good bills before us, H.R. 2167 and H.R. 1965, which would really modernize the 1934 Act. And I would like to start with Mr. Silbert, since you are my constituent, and ask you a few questions about H.R. 2167. It excludes accredited investors and employees from shareholder count that would trigger the registration under Section 12(g). Do you agree with that or oppose that?

And it requires the SEC to revise the term held of record to reflect the changes in shareholder numbers to provide safe harbors that can be used by a company to determine who is an accredited investor or receive shares through an employee compensation plan.

If you could comment on those two aspects of 2167? And also tell me, are you supporting 2167 and 1965? And what would it mean from a business point of view for these two measures to really update the 1934 Act?

Mr. SILBERT. First, thank you for the kind words, Congresswoman. Thank you for your support of the New York entrepreneur community. It means a lot to us job creators.

With respect to the exemptions from the counts, I think it is important to recognize that the increase from 500 to 1,000, the exemption of employee owners and accredited investors, they deal with three different types of, call it share holders.

So the reason why the accredited investors—it is important for them to be exempted out is this is going to be a way for these small companies to actually access capital, by making opportunity available to a broader group of investors.

If you are limited to 500 slots as it currently exists for all shareholders, companies that are growing fast and hiring a lot of employees don't have the ability to broadly make available investment opportunities to the accredited investor universe.

With respect to the employees, this to me is—it ultimately affects a company's ability to hire and compensate their employees. What is interesting is options in their form don't count towards the count. But once they invest and exercise, they do count towards the count. So we think that both of those are two important exemptions.

With respect to the held of record, I don't believe that the bill addresses the definition of record holders. But if it does, I would have to get back to you with an answer on that.

Mrs. MALONEY. Maybe they shouldn't have that definition.

Mr. SILBERT. I think that is more relevant on companies going from public to dark, which I think is kind of covered under the Community Bank bill, which—I apologize. H.R. 1965 is which bill?

VOICE. Himes.

Mrs. MALONEY. That is the Himes bill that amends the securities laws to establish certain thresholds for shareholder registration and for other purposes.

Mr. SILBERT. So I fully support that bill as well, because I think a lot of the same issues that you and Mr. Williams talked about in his testimony—it applies to whether you are a community bank or whether you are a fast-growing pre-IPO company, I think it is important to make those changes as well.

Mrs. MALONEY. Okay. Thank you. And Mr. Williams, who is representing the banking industry, under the Schweikert bill, this bill only—I am talking about the Himes bill—only applies to banks and bank holding companies. I would like to ask you how many banks would be affected by this change? And are you supporting the Himes bill, H.R. 1965?

Mr. WILLIAMS. We are certainly supporting the Himes bill. We think it is a good policy and a good change. The number of banks that are affected is subject to debate. But basically, we feel that there are at least 500 banks in our country that would benefit immediately.

I have the opportunity to travel around the country and visit with banks. And it just happened to me last night, here in Washington, meeting with a group of bankers from Florida and California. And a banker from Tallahassee caught me after the meeting and said, "I started a new bank 4 years ago, and I am not very large. I am up to about $120 million, but we are growing quickly and capital is really important to us. But we are already up to 400 shareholders."

The cost of registration he estimates to be $190,000 annually. That means in the ten to one ratio of capital to loans, that will decrease this bank's ability to make loans by nearly $2 million per year, which according to Bill here, would turn into 25 to 30 jobs each year with those small businesses that could obtain those loans. We are clearly supporting that legislation.

Mrs. MALONEY. I am supporting both of these bills. I would like your opinion on this one aspect. Should the shareholder of record definition be revised to only include individual investors? And if the definition was revised in this way, what would be the appropriate number of shareholders of record?

Mr. WILLIAMS. We believe we have worked under the current shareholder of record description for a number of years and that is a comfortable level to work with. But actually, in the banking industry, there is very little distinction, I believe, between the shareholder of record and the other definition.

We believe, based on our analysis, that a move from somewhere between 2,000 and 3,000 shareholders would keep us in line with what would be deemed adequate with the banking industry.

Mrs. MALONEY. Thank you. My time has expired.

Thank you, Mr. Chairman.

Chairman GARRETT. Thank you, Mrs. Maloney.

Mr. McHenry?

Mr. MCHENRY. Thank you, Mr. Chairman.

Ms. Mauriello, I appreciate your testimony and the efforts you are making to help entrepreneurs get access to capital.

In your experience, under SEC's Reg D Rule 504, you found that there is, in fact, a limited ability to do crowdfunding within this exemption. And that is how you found your place, as I understand it, and your ability to do your business.

What experience do you have? You mentioned this in your testimony, but if you can expand on it. What experience do you have with the limitations that complex SEC rules and then, furthermore, the State regulations, the impact they would have on crowdfunding?

Ms. MAURIELLO. Absolutely. So, on an SEC perspective, the complications come from lack of definition. For example, under Reg D 504, I can reach out to people with whom I have a substantial preexisting relationship.

That is incredibly difficult to define and to be made understood by someone who is saying, do my Facebook friends count? Does this type of person count? And we can provide as much transparency and information as exists to say people who have adequate information about your financial situation, etc. But those definitions are so vague that they are very difficult to comply with.

The same goes for sophisticated investors, "for being able to make their own decisions on investment." That is not sufficient to be able to allow sophisticated investors to be able to invest in a way that the counsel of the entrepreneur truly has confidence and being able to use this, and in a way that platforms can truly scale it, because we feel confident that we can stay in compliance.

On the State level, my biggest concern is that the greatest bill in the world could be put forward, but if the States can then say, actually, we don't like this and you can only have 10 investors in our State, despite what the bill at the national level says, which is what is happening with 504.

For instance, they call the case of—at the Federal level for 504, you can have 500 investors. Connecticut says you can only have 10 nationally. That really negates a lot of the good work that had been done on the Federal level.

And I think some of the intention behind the State regulation can stay by still having notice filings with the State. You can still have even the filing fees. You can still have the fraud protection measures, as you mentioned, while making it scalable.

Mr. MCHENRY. Mr. Abshure, can you respond to that concern about these complex regulations and these limitations through the focus that you are representing here today?

Mr. ABSHURE. Exactly. I think that I understand that industry's concern to effectively have one-stop shopping, go to one regulator. And I think that in this case, the one stop is the States.

And the States have, in the past, shown their ability to recognize the needs of small business and to facilitate capital raising transaction through model accredited—

Mr. MCHENRY. Okay. Actually, I am trying to get you to respond to Ms. Mauriello's specific concern. When you say only she used 10 investors in the State of Connecticut, do you have the similar limitation in the State of Arkansas?

Mr. ABSHURE. In terms of the number of investors under a 504 offering? If 504 is—no, we wouldn't have that in implementation.

Mr. MCHENRY. Okay. But then the folks that you are representing here today, is there a way to still have that filing? It would be less won risk and less expensive.

Mr. ABSHURE. Absolutely.

Mr. MCHENRY. So, you could go and raise $100,000 from 1,000 investors across the country.

Mr. ABSHURE. There is apparently an assumption that the States can't come together and come up with a better mousetrap in this scenario and the fact that—

Mr. MCHENRY. They haven't?

Mr. ABSHURE. We can.

Mr. MCHENRY. Yes, and we are still waiting, so this is really the concern I want you to answer.

Mr. ABSHURE. Yes.

Mr. MCHENRY. Can you alleviate Ms. Mauriello's concerns and her experience in trying to raise capital across State lines?

Mr. ABSHURE. I think it is up to the States to develop a program where we can say, this is the avenue, this is the route. I understand we don't disagree with the goal at all. We have issues with the root that crowdfunding wants to use to get to the goal. And we think that we can come up with a better route to get there.

Mr. MCHENRY. Okay. So, do you currently have oversight over—in the 1933 Act, they are considered to cover securities because of the interstate qualities of these securities.

Mr. ABSHURE. Yes.

Mr. MCHENRY. Now, if we had a similar security, right, which is what we are talking about with crowdfunding, why would that not fall under that 1933 Act exemption?

Mr. ABSHURE. The coverage securities under the 1933 Act included those securities that are traded on the nationally recognized exchanges. When you get to the private placement, the coverage securities are those that are issued pursuant to rules adapted under section 4(2). It is limited to 506.

Mr. MCHENRY. Okay.

Mr. ABSHURE. 505 securities aren't covered. 504 securities aren't covered.

Mr. MCHENRY. Mr. Molinari, how do you alleviate that concern? Could these crowdfunded securities, in essence, be done on a national platform that could get them under this 1933 Act in the very point that Mr. Abshure is saying, that the exemption is because they are on a trading platform at the national level?

Mr. MOLINARI. Absolutely, Congressman. I think when you look at this on a macro level, it is not just about the crowdfunding side of the equation. I think we are at a new era today. If we look at technology, platforms meeting broker-dealer applications or ATS', as the utility in the middle of the transaction, it becomes the barrier of entry when you start to look at accredited investors, State registrations, Federal regulation.

The flow of information, whether that is solicitation ban or other, gives us the parameter to have tracking, archiving, a level of transparency, and record-keeping that is readily available to the regulators. And you are creating new market infrastructure, starting to create new investment practices that we haven't seen before. So the short answer is yes, absolutely, we can.

Mr. MCHENRY. So, to Ms. Mauriello's concern about the cost of being a broker-dealer, is there a way that what you are discussing and, Ms. Mauriello, what you have discussed, in terms of having this platform for the exchange of these securities, but to do so for a smaller offering than Ms. Mauriello is currently working through? Let us say half a million dollars, a hundred thousand dollars?

Is there a way for what she is proposing—what Ms. Mauriello is talking about to fit in with the elements that you are discussing, with the national platform?

Mr. MOLINARI. Again, yes, 100 percent. I think when we look at the initiatives and start to think about the broker-deal a little bit differently, and focus a bit on the ATS, the Alternative Trading System aspects, the next level up from the broker-dealer. If you make that in an electronic software application, tremendous efficiencies in cost, tremendous efficiencies in disclosure and transparency. It is one of the very reasons why we start to GATE Impact.

Looking at the impact initiatives, some of the microfinance issues that are now evolving from lending practices that were more grant-oriented and kind of just the do good side of the equation, to create that into an investment practice. And we would love, frankly, to leverage our infrastructure, our broker-deal compliance, the ATS designations, with folks like ProFounder to create that new ecosystem, to be that utility in the middle that handles a lot of that compliance and regulation.

Mr. MCHENRY. Mr. Silbert, could SecondMarket facilitate this as well? What are your thoughts on this?

Mr. SILBERT. Yes, I think the issue is—and it has been highlighted that as a registered broker-dealer, the costs to conduct diligence on an issuer or small offering is cost prohibitive.

And so the idea of either running through an ATS or some type of new regulated entity, you have to be kind of—to find or describe, it makes perfect sense.

Mr. MCHENRY. So, something scalable?

Mr. SILBERT. Right.

Mr. MCHENRY. Okay. Thank you for your testimony. I am sorry I didn't get to the whole panel.

But, certainly, I appreciate your testimony and your willingness to be here. My concern with the purpose of the ban on general solicitation—I, obviously, want to limit fraud and certain communications that would lead to fraud.

But it seems like this ban from the SEC really is simply choking off capital right now. We want that capital to be able to flow. We want it to be done in an environment where we won't have fraud, so we can prevent fraud.

But I do think the scrutiny of mass markets can help. And technology is certainly a wonderful way to make that possible.

Thank you for your time and thank you for being here.

Chairman GARRETT. Thank you, Mr. McHenry.

Mr. Sherman?

Mr. SHERMAN. Thank you. At the end of the hearing, almost everything that could be said has already been said. So, I am going to mention some things that are just on the periphery of this hearing, on the theory that that will minimize the overlap.

The first is that we haven't dealt with FASB number two. That is the provision of the Financial Accounting Standards Board that requires businesses to write off as an expense all the money they invest in research. So, if you build a research building, that doesn't hit your earnings. If you do any research in the building, that does.

And certainly, small businesses are doing the high-tech work. It is bad accounting theory. It is just easier to carry out. But it is bad accounting theory to say money that is invested in 2011 to create research results that are going to be used in the future should be written off as an expense.

And I think that a lot of smaller companies are reporting far less earnings per share as a direct result.

The second comment I will make is that for most businesses in my district, access to capital means getting a bank loan. Now, that isn't the subject of this hearing, because that is another subcommittee's jurisdiction. But I look forward to doing everything possible in the full committee so that it is easier to get depository institutions to make loans not to—this is important for all of business.

We are talking here about companies going public and having hundreds of shareholders, going to the SEC and the dreams of the most ambitious small business people.

A lot of gas station owners in my district, their idea of access to capital is getting a loan so that they can put in new tanks. And that is not necessarily the SEC's function.

But I want to commend my colleagues on the Small Business Lending Enhancement Act, which would allow credit unions to make business loans to those in their field of membership.

And while that may not help anybody become the new—it may indeed help somebody become the new Google. It will certainly help the small businesses that are not looking for 400 shareholders and $40 million, but instead are looking for $40,000 to be able to make the investments they need to keep the business going.

And then, finally, as to the Wall Street—as to the provision on 404(b), I may be disagreeing with some of our witnesses here. But I do want to put in the record that the Counsel of Institutional Investors, the Center for Audit Quality, and others have opposed other efforts in our committee to permanently exempt companies of over $75 million in capitalization from the 404(b) audit requirements.

And it may be easier to do less auditing. It may be cheaper to do less auditing. But I have never met an investor who said, oh, gee, I wish I had less auditing.

Chairman GARRETT. Mr. Sherman? I do believe the ranking member put that letter in the record.

Mr. SHERMAN. I thank you and I am glad that has already been done. And with that, I am going to spare the witnesses. They have been through enough and I yield back.

Chairman GARRETT. Thank you. But do you really think we have put them through enough?

[laughter]

Mr. SHERMAN. These people are nicer than most of our other witnesses.

I promise you, I will not be nice some other day.

Chairman GARRETT. You are a very likeable group. But just for a couple of moments, sort of a quick prerogative because Mr. Abshure, you seem like a likeable soul and fairly creative.

You heard the story from Mr. Williams of some of the issues that were happening with some of the smaller banks and their ability to—hitting up against that share ceiling.

I know this is not necessarily within your regulatory specialty. But if you were to solve his problem in a way that would make you comfortable with your regulator hat on, what would you do?

Mr. ABSHURE. Specifically, the problem with small banks with the shareholder aspect?

Chairman GARRETT. Yes. Just purely running up against the ceiling.

Mr. ABSHURE. With regard to that question, that shareholder registration threshold, it strikes me as everyone involved understands the particular issues there. And I think that you have to balance. You have to determine when a company really becomes a public company.

And it is a balancing between the number of shareholders, but also really the assets and, perhaps, market cap. And I think that—

Chairman GARRETT. So, you would consider looking at other types of triggers other than just?

Mr. ABSHURE. Other than just the shareholder. Look, you can have a company that has two shareholders and a $2 billion market cap between those two.

The company is a balance. The size of the company is a balance between the number of shareholders and also the financial size of the company.

So, I think you have to balance those two.

Chairman GARRETT. Okay. That is a fair comment. Just an odd, one-off question for Mr. Silbert.

Has there ever been—we will call it a secondary market, even though I think you now have that copy written—that has traded—when an employee, you spoke about—okay, we can only, right now, give so many shares out to employees, but you give them an option for the future. Has anyone ever traded those employees?

Mr. SILBERT. Typically, with all private cap securities, there are restrictions on transfer. And in particular options, even once they invest, they are not transferable.

Chairman GARRETT. In that case, when you also look at the model you are building—let us say we had a small business, and either my piece of legislation or some of the others that are out there, where an employee is given so much ownership, but we restrict them, saying, it has to be held for 36 months and those types of triggers. How do you respect those rules when you are also creating a secondary platform to move those shares?

Mr. SILBERT. I think what is unique about SecondMarket is we are not creating an over-the-counter golden board in the back alleys. We are creating a registered, regulated, transparent, centralized platform, where the companies themselves are the ones that are setting the rules around how those securities can be traded.

So a company decides when they want to open up a liquidity window. The company gets to decide how many buyers and which buyers are allowed in to their market. The company gets to decide if there are restrictions on employee sales.

So, from that perspective, the market will be customized to the companies' objectives, versus forcing the company to comply with the public market roles, which is not a one-size-fits-all.

Chairman GARRETT. And forgive me if I mispronounce your name, Ms., is it "Mauriello?"

Ms. MAURIELLO. Yes.

Chairman GARRETT. In some of the, we will call them placements, you have been involved in, how helpful has the Internet been? Do you have some of these small investors? Are they using the Internet to vet the company and the concepts?

Ms. MAURIELLO. It is extremely challenging for them to use the Internet and take best advantage of the power that it has, because of the prohibition on general solicitation. But it has some value.

For example, our issuers will create their business plan and create their term sheet and put those on a private fundraising Web site that they will then be able to e-mail the people who they have a substantial pre-existing relationship with, under 504, to be able to invest directly through.

It is helpful to be able to view the information in a centralized place, to be able to share new information, etc. But what they all come back to us and say is, why can't I send out a link that they can send to their friends, also someone whom I have a relationship with, but I might not have thought of.

So, the way the regulation is set in place is very difficult to explain to the common person, who has used normal Internet practices, and see that they have to use the Internet in a very different way and almost an illogical way than what they are used to.

Chairman GARRETT. As a one-off, have you ever seen some of these small investors create a social media of some fashion to either discuss the concept, the marketplace, as more of an investor instead of the actual person doing the offering?

Ms. MAURIELLO. If the investors have discussed amongst themselves?

Chairman GARRETT. Yes? Or just even put it out saying, give me input.

Ms. MAURIELLO. Exactly. They are all scared to, because they know they can't generally solicit. Their counsel has battered than over the head with this. We remind them of this all the time. So, they are scared. They want to stay as conservative as possible.

What we encourage them to do is to talk about their idea and before you ask someone for money, you should ask their advice. You should make them aware of what you are doing with their business. So, we do encourage them to do that as a separate matter, just as good business practice.

But within the offering, everyone is far too scared to touch that.

Chairman GARRETT. Thank you. We are entering into, in many ways, sort of a brave new world, where our access to information is so radically different today than it was even a decade or 15 years ago. And I keep hoping we are going to find that sweet spot where information is the ultimate regulator here.

And in some ways, our desperate hunger for capital for the small job-creating growth industries might be also the same time where we also get to find out the future of the regulatory environment. Do we have—oh, I am sorry, Mr. Himes. I didn't even see you sneaking up on me.

Mr. HIMES. Thank you, Mr. Chairman. Let me thank the panel for your very, very helpful and useful testimony. I have a couple of questions. I want to come back to this crowdfunding issue.

So, I have some questions for Ms. Mauriello. I want to say, though, there was a sort of spirited back-and-forth with Mr. McHenry. I am not trying to set this up as an antagonistic situation. I honestly don't know whether this is a good idea or not. I am trying to get at it.

I think the core of my concerns with crowdfunding is that the underwriting process in the case of debt or the process by which an individual or an institution decides to make an equity investment is essentially a process of getting to know somebody.

When you are going to lend to somebody, you don't just look at interest coverage and the ability to repay. You actually get to know the individual.

Ms. MAURIELLO. Yes.

Mr. HIMES. To me, that is the core of the investment decision. What worries me is nothing specific about the Internet or eBay or anything else. But what worries me is that, by definition almost, crowdfunding takes away that getting-to-know-you element.

So, I have two questions for you, Ms. Mauriello. I would like you to respond to that more generally. But also in your testimony, you have talked about your days as a student at Stanford and you said you had great ideas and people wanted to fund them, but that it couldn't happen.

Under Federal law, it is only companies with assets in excess of $10 million, and even then under Reg D, you can do 35 or 34, not 35, non-accredited investor. So, what was actually keeping those Stanford students from investing in each others startups?

Ms. MAURIELLO. Sure. On that particular question, it was fear on behalf of their counsel, because the regulation was unclear about the specifically sophisticated investor clause and what that meant.

So, they ultimately wound up doing it through Regulation D 506, after a number of months and about $20,000 in legal expenses to get there, because their lawyer said, yes, you can have 35 sophisticated investors. But there is no standard SEC issue tasked for what sophisticated investor means.

There is a level of risk to take on saying that somebody is sophisticated. So they ultimately, out of 60 people who were interested, could take on 35 who would fit under 506. Would you like me to address the getting-to-know-you as well?

Mr. HIMES. That is actually really my concern. We hear story after story about people starting businesses with credit cards and second mortgages.

This is the way it has always been done, angel investors. With credit cards and mortgages, there is recourse for you. That will focus the attention.

Ms. MAURIELLO. Right.

Mr. HIMES. If it is friends and family and mothers-in-law, that will focus your attention. This seems to me to do away with that relationship, which is both about information and data, but also about just sizing up the individual and that individual's character. Is that not lost in this process?

Ms. MAURIELLO. I don't think it has to be. I think it could be. It really depends the way the investor protection is written, right?

So, there are two points. One is on disclosure. So, I think there is a certain level of disclosure which is necessary to make information available, that is also not too prohibitive. For example, the level of disclosure in 506, many small issuers were doing $20,000, etc., find that to be prohibitive.

There is a balance there. But secondarily, I mentioned one suggestion for investor protection around qualifying the issuers. All the deals that we have done so far are through 504, because the way it is written there is within communities. It is truly community investing.

Ricky Puthiya has a coffee shop in Montana. His community, his neighbors, the people who know Ricky best, looked into this opportunity and decided to invest. I think that is the most common way that we are going to see crowdfunding happen.

I am really excited and encouraged by the way the bill is being written and it is being talked about to create unlimited potential. At the end of the day, how I think the majority of people will use it is within communities to be able to invest.

So, what I put forward as a suggestion for qualified investors is that if you know the person, if you are local to that person, or if you are a sophisticated investor and are deemed to be able to make good decisions based on the disclosures alone, you should be able to make that investment.

That is how I would suggest addressing the getting-to-know-you issue.

Mr. HIMES. Okay. Thank you. I appreciate that.

One question for Mr. Molinari. I appreciate your testimony, Mr. Molinari. Something caught my eye, though. In your testimony, you said that Sarbanes-Oxley and the Dodd-Frank Wall Street Reform and Consumer Protection Act are limiting the ability of benefits to smaller private companies that are going public. I have heard the Sarbanes-Oxley they wanted before.

But, of course, Dodd-Frank, which we spent a lot of time on in the last Congress, really applies largely to financial institutions and has broad exemptions for smaller financial institution.

I wonder if you can walk me through the mechanism by which you think Dodd-Frank specifically inhibits the ability of non-financial companies to raise capital.

Mr. MOLINARI. I think when you look at it, Congressman, it is the macro theme of looking at the IPO more. Looking at the macro theme that the small to mid-sized public offerings in our country have been dramatically reduced. And we can go over statistic after statistic.

Mr. HIMES. I know that. And look, we all know what happened in the market. I am curious about the specific mechanism by which the Dodd-Frank legislation—which of the rule writing not, of course, having been completed is inhibiting capital raising of nonfinancial companies?

Mr. MOLINARI. You say nonfinancial as private companies.

Mr. HIMES. You say smaller private companies, yes.

Mr. MOLINARI. I think it is the concerns of being public and going public relative to those costs associated across the spectrum of overreaching regulation, perhaps, where we have private companies that need to grow further, that are budding up against certain issues. And I know we are talking about more issues.

Mr. HIMES. But just to stop you, because I am running out of time. I do appreciate the answer. Sarbanes-Oxley imposed a substantial regulatory burden, as does the SEC, on public companies, but you think a lot of Dodd-Frank here.

I am just wondering, does Dodd-Frank, in fact, impose regulatory burdens on nonfinancial companies, small company?

Mr. MOLINARI. Not as much. As we point out, Dodd-Frank is more a macro regulation that is affecting the marketplace, not necessarily drilling down to the specifics in this instance.

Mr. HIMES. Okay. Thank you very much. Thank you, Mr. Chairman.

Chairman GARRETT. Thank you, Mr. Himes, though you live dangerously if you are raising money from the mother-in-law.

[laughter]

Chairman GARRETT. Talk about recourse.

[laughter]

Chairman GARRETT. Oh, yes. And that was the entertainment portion of our program.

[laughter]

Chairman GARRETT. In that case, we are done. I just have to read a couple of statements here. And I know the committee wants to thank you very much.

As I often say, particularly for a couple of you, it may be your first time to testify here, if you look out in the room and don't see a lot of faces staring back at you, understand that there are faces staring at you all over the building.

It is something you get to used to, as you are on televisions everywhere. And a lot of folks don't realize how much they are being watched. That is what gets me in trouble when I try to be amusing up here.

All right, statements for the record. We have: the U.S. Chamber of Commerce; the Independent Community Bankers of America; Burroughs & Chapin Company; and the Credit Union National Association have all submitted letters. And they will be placed in the record without objection. So ordered.

The Chair notes that some Members may have additional questions for these witnesses which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

And with that, our committee is finished. Thank you all.

Mr. MOLINARI. Thank you.

Ms. MAURIELLO. Thank you.

[Whereupon, at 12:40 p.m., the hearing was adjourned.]

A P P E N D I X

September 21, 2011

Testimony of Heath Abshure

Arkansas Securities Commissioner and

Chairman of the Corporation Finance Section Committee

North American Securities Administrators Association, Inc.

Before the

House Subcommittee on Capital Markets and Government Sponsored Enterprises

"Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation"

September 21, 2011

Introduction:

Good morning Chairman Garrett, Ranking Member Waters, and members of the Subcommittee, I'm Heath Abshure, Securities Commissioner for the State of Arkansas and Chairman of the Corporation Finance Section Committee of the North American Securities Administrators Association, Inc. ("NASAA"). NASAA is the association of state and provincial securities regulators. I have a keen interest in issues regarding capital formation and I was pleased to accept an appointment on September 13 as an observer member of the SEC's Advisory Committee on Small and Emerging Companies. This SEC Committee will explore ideas designed to reduce the regulatory burdens on small business capital formation in a manner consistent with investor protection. I am honored to be here today to discuss legislative proposals related to small business capital formation.

State securities regulators have protected Main Street investors from fraud for the past 100 years, longer than any other securities regulator. State securities regulators continue to focus on protecting retail investors more so than any other regulator. Our primary goal is to act for the protection of investors, especially those who lack the expertise, experience, and resources to protect their own interests.

The securities administrators in your states are responsible for enforcing state securities laws by pursuing cases of suspected investment fraud, conducting investigations of unlawful conduct, licensing firms and investment professionals, registering certain securities offerings, examining broker-dealers and investment advisers, and providing investor education programs and materials to your constituents.

Ten of my colleagues are appointed by state Secretaries of State, five are under the jurisdiction of their states' Attorneys General. Some, like me, are appointed by their Governors and Cabinet officials. Others, work for independent commissions or boards. Many call us the "local cops on the securities beat."

I think of my state colleagues at NASAA as a national network of local crime fighters working to protect investors. Securities regulation is a complementary regime of both state and federal securities laws, and the states work closely together to uncover and prosecute securities law violators.

The Distinguished Enforcement Record of the States

States have been the undisputed leaders in criminal prosecutions of securities violators because we believe in serious penalties for securities-related crimes.

In 2010 alone, state securities regulators conducted more than 7,000 investigations, leading to nearly 3,500 enforcement actions, including more than 1,100 criminal actions. Moreover, in 2010, more than 3,200 licenses of brokers and investment advisers were withdrawn, denied, revoked, suspended, or conditioned due to state action.

The enforcement actions performed by state securities regulators last year represent a 51 percent increase over the number of investigations reported for the previous year; however, this impressive record builds upon an already strong foundation of regulation at the state level. Since 2004, state securities regulators have conducted over 14,100 enforcement actions, and secured convictions for securities laws violators resulting in more than 5,600 years in prison.

Traditionally, state securities regulators have pursued the perpetrators at the local level who are trying to defraud the "mom and pop" investors in your states, leaving the SEC to focus on the larger, more complex fraudulent activities involving the securities market at a national level.

Even so, states have investigated violations on a national level such as the successful state effort to expose and force Wall Street to correct rampant conflicts of interest among stock analysts. We led all regulators on late trading and market timing in mutual funds. And state securities regulators continue to lead the nationwide effort to address problems related to the offer and sale of auction rate securities, an effort that has resulted in the largest return of funds to investors in history.

State Securities Regulation, Investor Protection, and Job Growth

Let me begin by telling the Subcommittee that state securities regulators are acutely aware of the difficult economic environment and its effects on job growth. In Arkansas, I see the recession's impact on small business on a daily basis. Let me also assure the Subcommittee that no state securities regulator seeks to inhibit economic recovery through regulation that is overly burdensome or restrictive.

Arkansas and other states are committed to fostering responsible job growth and capital formation because we all recognize that America's small business community is an important component of a strong economy. Moreover, state securities regulators recognize that although there is no silver bullet for getting small businesses growing and hiring, increasing their confidence in their ability to raise revenue and access capital is crucial.

While Congress' desire to facilitate access to capital for new and small businesses is warranted, it must be sure do so in a careful and deliberate fashion. Investors must be assured that they are protected to the fullest extent possible. This will in turn promote investor confidence in the very markets Congress is seeking to grow. Investor confidence is key to the growth of these markets. Without it, the measures under consideration are unlikely to succeed. If investors have no faith that small business offerings are being regulated reasonably, they will not invest in small business offerings. Our efforts to facilitate capital formation by small business will be in vain.

In the same way small business investment has the potential to be a very positive economic force and major driver of wealth and jobs when done in the right way, it also has the potential to become a costly failure that undermines market discipline and places Main Street investors at risk if done recklessly.

By ignoring smart regulation and the crucial role of state securities regulators, Congress could enact policies intended to strengthen the economy that have precisely the opposite effect.

Defining "Obstacles" to Small Business Capital Formation

Historically, small start-up businesses obtained capital from a number of different sources, including friends and family, credit cards, home equity loans, bank loans, nonbank loans, angel investors, venture capitalists, and private and government investors providing Small-Business Administration (SBA)-sponsored financing.

The critical questions are: Have these sources stopped funding small businesses? If so, why? The answers to these questions should dictate the universe of proposals Congress should entertain.

If the answer is that funding is not available because banks are not lending as they should, or because traditional sources of small business capital are unavailable even to well-qualified, established, or very promising small business endeavors, then this has the potential to stifle small business growth and hurt the economy. Therefore, Congress might consider certain steps to minimize or remediate this needless loss of productivity.

On the other hand, if the answer is that traditional sources of small business capital have reviewed the particular small business applicant and determined that the risk is too great, then we should not allow that applicant to seek investment from unsophisticated, "mom and pop" investors without appropriate investor protections. The typical retail investor, unlike the traditional small business financier, does not have the ability to conduct a reasonable investigation of a start-up or development-stage entity.

The methods of facilitating small capital formation must reasonably balance the needs of businesses with the needs of investors. To do so, they must ensure that the methods are available only to those entities that need it, rather than all that profit from using it. Regulation A has long excluded those entities that are required to file under the Securities Exchange Act of 1934. Shouldn't there be a new asset cut-off in the case of businesses offering securities under H.R. 1070 or H.R. 2930? If the point is that small businesses should be entitled to a different regulatory approach than larger businesses, any special treatment should be limited to the appropriate small business issuer.

Further, there can and should be a way to ensure that fraudsters cannot use these financing methods to fleece unsophisticated investors. Again, this is a question of finding the correct balance for businesses, for investors, and for the economy.

How a Regulatory Gap Helps Unscrupulous Promoters Fly Under the Radar of Justice

As the closest regulators to the investing public, state securities regulators see first-hand the dangers investors face when that balance is off. Consider the real-life impact to the investing public in the years since the SEC approved Regulation D, Rule 506 of the Securities Act of 1933 in 1982.

This rule expanded the registration exemption to include certain securities marketed through private placement offerings. Private placements offer businesses the opportunity to raise capital by selling securities to a relatively small number of investors as opposed to a public offering made through national securities markets.

Companies using the Rule 506 exemption can raise an unlimited amount of money without registering the offering with the SEC as long as they meet certain standards. Although the SEC has performed limited reviews of private offerings since 1982, they had been subject to regulatory review by state securities regulators who routinely screened bad actors from raising money through private securities offerings. This regulatory authority was stripped from the states in 1996 when Congress passed the National Securities Markets Improvement Act (NSMIA). As a result, today private offerings receive virtually no regulatory scrutiny.

Since NSMIA became law, the use of the securities exemption found in Rule 506 has increased significantly. Although properly used by many legitimate issuers, the exemption has become an attractive option for individuals who would otherwise be prohibited from engaging in the securities business.

Today, the exemption is being misused to steal millions of dollars from investors through false and misleading representations in offerings that provide the appearance of legitimacy without any meaningful scrutiny of regulators. Private placement offerings have been identified by NASAA as a top trap facing investors in three out of the past five years. Here's why:

- In 2005, the 55-year-old owner of a North Carolina cleaning service was surfing the Internet when a "pop-up" window appeared on his screen requesting personal information. What soon followed was a variety of investment opportunities ranging from oil and gas ventures to real estate deals and body scanning. A phone call followed with a sales pitch soliciting a $15,000 investment in Lifeline Imaging, a California medical diagnostic business. The deal sounded good and the investor, together with his wife, borrowed money from their retirement savings and followed the salesman's instructions to transfer their funds to a designated account. After months without word of the investment's status, the investor checked his investment account. It was empty.

- In 2007, a 72-year-old, Alabama man living on disability checks became the target of a series of cold calls pitching a variety of limited offerings, including Lifeline Imaging. His $25,000 investment in the business has vanished. After investing $90,000 from a large insurance settlement in Lifeline Imaging, another disabled Alabama man was pressured by sales agents to take a mortgage on his home to invest additional funds in Lifeline. Family members intervened and refused the mortgage, but the initial $90,000 was lost.

- In Oregon, Sunwest Management Inc., a major corporate operator of assisted-living facilities, raised at least $300 million from more than 1,300 investors nationwide by promising a steady income stream and the successful operation of hundreds of retirement homes. Working with the Oregon Division of Finance and Corporate Securities, the SEC in March 2009 charged the multi-billion enterprise with operating a securities fraud. In September 2009, Oregon securities regulators proposed fining Sunwest $8 million, claiming the firm misled investors, misrepresented the true condition of the company, and used unlicensed salespeople to sell unregistered securities.

In 2011, U.S. and Canadian authorities convicted three individuals of criminal fraud charges related to the sale of $33 million in oil and gas private placement offerings. The defendants claimed the securities were exempt from registration under Rule 506. In an attempt to avoid regulatory scrutiny, the defendants organized their company in the Bahamas and sold the securities from a boiler room located in Ontario, Canada, while telling investors the company was located in Kentucky. Securities regulators also have taken civil fraud actions against private placement issuers, Medical Capital Holdings, Inc. and Provident Royalties, which raised more than $500 million from investors though private offerings sold by dozens of broker-dealers. The companies are alleged to have defrauded investors by misrepresenting the use of the investment proceeds and misappropriating millions in investor funds.

In these examples and numerous other cases, the provisions of Rule 506 and other limited or private offering provisions are being used by unscrupulous promoters to evade review and fly under the regulatory radar.

Each year, more than 20,000 private offerings are filed with the SEC. According to the SEC's Office of the Inspector General (OIG), in 2008 issuers sought to raise more than an estimated $609 billion from investors through Regulation D, Rule 506 offerings.[1] The same report concluded the agency does not give these offerings a substantive review. The SEC's own internal watchdog found that the agency's Division of Corporation Finance "does not generally take action" when it learns that issuers have failed to comply with the requirements of the Regulation D exemptions.

The OIG Report reinforces the conclusions reached by state securities regulators: there is little or no action taken by the SEC regarding Regulation D filings, and this has created a significant regulatory gap. The current structure of Regulation D, Rule 506 does not afford state securities regulators with an opportunity to review or deny these Rule 506 offerings ***before*** they are offered to investors in their states. A substantive review of these offerings, which was a function the states served prior to enactment of NSMIA, is essential to protect investors. As the Subcommittee considers various capital formation bills, we urge you not to exacerbate NSMIA's harmful effects.

Balance and Responsibility

There is no question that small business capital is vital to our economy. However, any legislation designed to foster the flow of capital to small businesses must be done responsibly.

For example, we just returned to Kansas to celebrate the 100th anniversary of investor protection statutes known commonly as "Blue Sky laws." Kansas was the first state to enact such laws in 1911. It has been said that it was an effort to prevent the sale of securities by promoters who

[1] SEC Inspector General's Report on Regulation D Exemption Process; March 31, 2009; available at http://www.sec-oig.gov/Reports/AuditsInspections/2009/459.pdf.

promised rain, but delivered only "blue sky." Following the stock market crash of 1929, the federal government began to regulate investment activity with the creation of the SEC in 1934.

I give this example because, as I mentioned, the states are mindful of the economic environment. For example, the Office of the Kansas Securities Commissioner recently announced a new exemption, the Invest Kansas Exemption, which will allow Kansas businesses to raise up to $1 million from investors without registering the securities with the state. Other states have similar and unique initiatives.

In Arkansas, our mission statement is "to promote an environment in which the securities and financial markets within the department's jurisdiction function efficiently and without unnecessary regulatory impediments," but just as importantly, our goal is to protect the "financial well-being of Arkansas citizens through effective consumer protection and education."

Small Business Capital and Investment Risk

The witnesses here today will likely argue perceived benefits that will accrue to the economy and nation through greater access to capital with less regulatory oversight. They will likely tout potentially high returns and rapid growth. They will not, however, speak substantially to the many, many risks associated with investments in small businesses, and particularly small business start-ups. Nevertheless, the potential and significant benefits to small businesses are, fundamentally, one side of a two-headed proposition, with the other side of the story being the high risk and potential loss to investors.

Clearly there should be opportunities to invest in small businesses. However, given the risky nature of such investments, these opportunities should be made available to investors who understand the risk and have the financial wherewithal to handle any losses that may come as a result of the investment. The truth is that investments in small businesses are typically suitable for only those investors sophisticated enough to understand the unique risk associated with such investments. Statistics show that unfortunately, roughly 50 percent of small businesses fail within the first five years.[2] Even in the risky universe of small business investment, start-up business investments are extremely speculative and carry a high risk of failure.

This means that Congress must be cognizant of the many real and well-established risks associated with investing in small businesses and "start-ups" in particular.

"Start-Ups" and Their Attendant Risks

Small business "start-ups" in particular are risky because investments made in this area are often entirely illiquid. Since there is no market for the product or service in question, once in, there is no guarantee investors can get out.

[2] U.S. Small Business Administration. http://indus.sba.gov/smallbusinessplanner/plan/getready/SERV_SBPLANNER_ISENTFORU.html

In addition, small business start-ups tend to have little or no operational history, or, put another way, little or no experience. Moreover, the company's business model, intellectual property, and technology are untested. In sum, like it or not, many small business investments are undeniably replete with risk for investors.

Regulatory Balance Between Businesses and Investors

The success of small business is, in many respects, America's success, and one of the things we will need to do to get America moving forward again is to encourage small business growth and entrepreneurship. In the midst of a prolonged period of high unemployment and slow economic growth, this appeal grows even stronger. Many of us have seen businesses disappear since the financial crisis, not due to the inability to compete, or due to shortcomings in their business plan or the goods and services they produce, but due to their inability to get loans from banks.

The challenge for Congress today is to find policies that achieve the right balance between the competing objectives of promoting investment in real and valid business opportunities and protecting citizens from inappropriate risk and fraudulent schemes. Finding the right balance may be difficult, but the states stand ready to work with Congress and the SEC to ensure that this balance is achieved.

Capital Formation Legislation Pending before the Subcommittee

The Small Company Capital Formation Act of 2011 (H.R. 1070)

As the Subcommittee is aware, NASAA had significant concerns regarding the original version of this legislation, which was considered by the Subcommittee last June. As noted in my letter on June 20 to the Subcommittee Chairman Garrett and Ranking Member Waters, one of the most fundamental investor protections currently embodied in Regulation A is the review and oversight of Regulation A transactions by state securities regulators. Considering the nature of the typical Regulation A offering, the need for oversight and review by the state securities regulators is even more acute. H.R. 1070 placed this important investor protection mechanism in jeopardy.

Under Section 18 of the Securities Act of 1933, states are preempted with regard to registration or qualification of "covered securities." Section 6 of H.R. 1070 states that Regulation A securities that are not sold through a broker-dealer shall not be covered securities under Section 18. By implication, under Section 6 of H.R. 1070 as then written, Regulation A offerings that are sold through a broker-dealer would be considered covered securities, and state review of these offerings would be preempted. The preemptive purpose of this provision is made clear by the title of Section 6, "Exemption from State Regulation."

In the intervening months, Representative Schweikert and his staff have worked with NASAA to improve and refine the legislation with respect to state authority, including a proposal to remove the critical provision when this bill is considered by the full House.

While NASAA harbors some concerns regarding the dollar amount of potential offerings under H.R. 1070, we believe that the states' ability to review these offerings, along with the SEC's proper exercise of discretion in creating reasonable reporting requirements for issuers, will prove to achieve a proper balance of the issuers' needs with investor protection. Accordingly, NASAA no longer actively opposes H.R. 1070. We hope to continue to work with its sponsors in the House to improve this legislation as it works its way through the legislative process.

The Entrepreneur Access to Capital Act (H.R. 2930)

Many of the same investor protection concerns we raised with H.R. 1070, we now have with H.R. 2930. This bill would create a new exemption from registration for securities offerings known commonly as crowdfunding. This bill would deregulate "crowd-funding" offerings for an offering amount up to $5 million, and a maximum investor contribution of $10,000 per investor.

Moreover, H.R. 2930 would award these offerings "covered securities" status and preempt state law with regard to registration and qualification of these securities. It is crucial that the states keep their authority to review securities offerings, especially those of potential issuers under H.R. 2930. These are often high risk offerings, and there has been significant fraud in this segment of the market. Also, because offerings under H.R. 2930 will not be subject to federal registration, and because such companies do not issue ongoing reports like true public reporting companies, the protections provided by state review are even more essential.

I am concerned that some crowdfunding proposals contemplate substantial preemption of state authority. States have been vigilant in protecting retail investors from the risks associated with these securities. State authority to continue to review and police these investments must be preserved. Any crowdfunding proposal should consider carefully the loss of investor protection that a partial or complete preemption of state regulation would cause.

Under the current proposal, there will be no verification that the issuing companies actually exist. With no notice, there is no ability for a state to be certain that the issuer is really a business entity and really has an address. Further, there is no disqualification provision so that bad actors can't use it. This would result in an enforcement nightmare.

As H.R. 2930 is drafted, the caps on these offerings are simply too high. A fraudulent or unsound offering of up to $5 million could do considerable economic damage. A loss of up to $10,000 would be a crippling loss for many investors. (A 2009 survey indicated that 53 percent of American households had less than $25,000 in total savings and investments.)[3] While $10,000 does represent a significant loss for most investors, it is also so small that investors will be unable to reasonably pursue private causes of action against fraudulent issuers. For this reason alone, the ability of states to pursue enforcement actions in cases of fraud must be preserved.

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[3] According to the Employee Benefits Research Institute's 2009 Retirement Confidence Survey, 53% of workers in the U.S. have less than $25,000 in total savings and investments. http://www.ebri.org/files/FS-03_RCS-09_Saving.FINAL.pdf

However, many of these potential fraud cases will never occur if there is a reasonable system of disclosure designed with the crowdfunding issuer in mind.

As the Subcommittee considers various approaches to crowdfunding, we urge you to consider the SEC's recent experience in this area, as was discussed by the SEC Director of Corporation Finance, Meredith Cross, just last week in her September 15 testimony before the House Oversight and Government Reform Committee.[4] She noted that the Commission's rules previously included an exemption, Rule 504, which allowed a public offering to investors (including non-accredited investors) for securities offerings of up to $1 million, with no prescribed disclosures and no limitations on resales of securities sold. In 1999, that exemption was significantly revised due in part to investor protection concerns about fraud in the market in connection with offerings conducted pursuant to this exemption. As Ms. Cross stated, in assessing any possible exemption for crowdfunding, it would be important to consider this experience and build in investor protections to address the issues created under the prior exemption.

SEC Chairman Mary Shapiro has stated that the Commission's recently formed Advisory Committee on Small and Emerging Companies, on which I serve, will be reviewing crowdfunding and other capital-raising strategies.[5] I look forward to this opportunity to work with the Subcommittee members, the SEC, and Congress to develop a balanced and reasonable approach to crowdfunding. I hope that this approach establishes a disclosure system enabling crowdfunding investors to make a reasonably informed investment decision. I am aware that there are many factors to consider. These include the size of the issuer and its ability to absorb the costs of providing necessary disclosure. These must be weighed against the investor's need for meaningful and accurate disclosures about the issuer's business plan, financial health, and management. Further, any proposal should include disqualification provisions so that "bad boys" do not use crowdfunding to continue their fraudulent activities.

The Access to Capital for Job Creators Act (H.R. 2940)

The Access to Capital for Job Creators Act, H.R. 2940, will allow general solicitation in Rule 506 offerings. I have already noted the states' experience with Rule 506 offerings after NSMIA preempted state regulation. As the Subcommittee is aware, Rule 506 is a safe harbor under Section 4(2) of the Securities Act of 1933. These securities are meant to be private offerings. With this expansion, we are getting further and further away from the ideas of a private offering under Section 4(2).

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[4] SEC Corporation Finance Division Director Meredith Cross testified on September 15, before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs of the U.S. House of Representatives Committee on Oversight and Government Reform, that the Commission "fully expects that the input from the advisory committee, as well as the input we receive from the public, will be helpful to the Commission as it considers these matters.

[5] Id.

NASAA respectfully notes for the Subcommittee that when there is no limit on the number of offerees, the size of the offerings, or the manner of offering, it is a public offering. The fact that you sell only to accredited investors (and up to 35 unaccredited investors) does not change the public nature of the offering. Further, it is going to be impossible to limit the sale to only accredited investors when they advertise to everyone. Indeed, there will be no reason to believe that any investor, seduced by the public advertising, will hesitate to be dishonest when completing the investor suitability questionnaire. Given the amount of fraud and investor losses, NASAA has significant concerns about H.R. 2940 and believes there is a more reasonable way of doing this. Again, we need to balance the reasonable needs of businesses with reasonable protection of investors.

One option for the Subcommittee to consider is the Model Accredited Investor Exemption ("MAIE"), which was adopted by NASAA in 1997. This exemption, subsequently adopted by 32 states, maintains appropriate investor protections while giving small businesses the ability to conduct general solicitation and a cost-effective means to raise capital.

The MAIE allows the issuer to use a general advertisement to "test the waters." There is no limit on the number of investors under the MAIE, and there is no limit on the amount an issuer may raise in an offering under the MAIE. Although only accredited investors may purchase securities offered through the MAIE, dissemination of the general announcement of the proposed offering to non-accredited investors will not disqualify the issuer from claiming the exemption. The MAIE also contains a number of important provisions that reflect the speculative nature of the offerings and the need for reasonable investor protections, such as limiting sales to accredited investors. Moreover, the MAIE is not available to issuers in the development stage that either have no specific business plan or purpose, or have indicated its business plan is to engage in a merger with an unidentified company.

Small businesses, typically with no operational history, untested technologies, and limited resources, are extremely speculative. It is absolutely vital that any efforts to lessen the requirements of the capital-raising process for these companies maintain appropriate, necessary investor protections. The MAIE, or a provision containing similar protections, is a reasonable middle ground that was adopted by NASAA. This is an option that should be examined to ensure that investors understand adequately the risks of these speculative and historically illiquid securities.

Rather than passing H.R. 2940 in its current state and further limiting states' ability to protect investors, Congress could instruct the SEC to adopt an exemption to coordinate with this model exemption.

Conclusion

As regulators, states are guided by the principle that every investor deserves protection and an even break and has the right to not be cheated or lied to. As we saw with the passage of NSMIA in 1996, state securities regulators have been handcuffed from reviewing certain offerings before they were sold to members of the public. Since then, a regulatory black hole has emerged to expose investors to high-risk investments offered by companies with little or no financial stability or regulatory scrutiny.

In the 15 years since NSMIA became law, it has become painfully clear that preemption of state review of offerings is a failed experiment. We must not let history repeat itself by creating more regulatory black holes and exposing investors to unacceptable levels of risk and outright fraud.

State regulators understand the complex challenges faced by small business issuers. We also understand that a reasonable balance of the issuers' interests and the investors' interests is in the best interest of both groups. It protects the investors, and it facilitates the market for the issuers' securities. If the investors do not trust the small business issuer market, they will not invest.

The states are ready to play an active role in balancing these two interests. We believe that reasonable registration or exemption provisions can be adopted that benefit only those issuers for which they are designed, disqualify "bad boys", and provide for reasonable investor qualifications and protections. Further, we remain adamant that these provisions must preserve the ability of states to protect the interests of investors.

Testimony on "Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation"

by Meredith B. Cross
Director, Division of Corporation Finance
and Lona Nallengara
Deputy Director, Division of Corporation Finance
U.S. Securities and Exchange Commission

Before the Subcommittee on Capital Markets and Government Sponsored Enterprises
U.S. House of Representatives
Committee on Financial Services

September 21, 2011

Chairman Garrett, Ranking Member Waters, and members of the Subcommittee:

My name is Meredith Cross, and I am the Director of the Division of Corporation Finance at the Securities and Exchange Commission. I am accompanied today by Lona Nallengara, Deputy Director of the Division of Corporation Finance. We are pleased to testify today on behalf of the Commission on the topic of capital formation.[1]

The mission of the Securities and Exchange Commission is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. A critical goal

[1] Ms. Cross's participation in this testimony does not include matters related to crowdfunding. Prior to joining the Commission staff in June 2009, Ms. Cross served as counsel to a company in connection with its registration under the Securities Act of 1933 of notes offered and sold through its "peer-to-peer" lending platform. Although Ms. Cross has no financial or other interest in her former client or her prior employer, in light of the small number of participants in that market, in order to avoid any appearance concerns, she does not participate in matters involving peer-to-peer lending. Further, since there are some similarities between peer-to-peer lending and some crowdfunding concepts, even though Ms. Cross has been advised by SEC Ethics Counsel that there is no conflict of interest, Ms. Cross has determined that in order to avoid any appearance concerns, she will no longer participate in crowdfunding matters. For purposes of this testimony, Mr. Nallengara will address crowdfunding matters.

of the SEC is to facilitate companies' access to capital while at the same time protecting investors. Companies of all sizes need cost-effective access to capital to grow and develop, and the Commission recognizes that any unnecessary or superfluous regulations may impede their ability to do that. At the same time, the Commission must seek to ensure that investors have the information and protections necessary to give them the confidence they need to invest in our markets. Investor confidence in the fairness and honesty of our markets is critical to the formation of capital, and the protections provided by the securities laws are critical to large and small company investors alike.

Over the years the SEC has taken significant steps, consistent with its investor protection mandate, to facilitate capital-raising by companies of all sizes and to reduce burdens on companies making offerings, be it through introducing or increasing eligibility for shelf registration or implementing small business reforms. Going forward, the Commission will continue to consider and, if appropriate, implement changes to its existing rules to reduce regulatory burdens while maintaining important investor protections provided under the securities laws.

Indeed, a few months ago, Chairman Schapiro instructed the staff to take a fresh look at some of our offering rules to develop ideas for the Commission to consider that may reduce the regulatory burdens on small business capital formation in a manner consistent with investor protection. The staff's review is focusing on a number of areas, including:

- the number of shareholders and other triggers for public reporting;
- the restriction on general solicitation in private offerings; and

- restrictions on communications in public offerings.

Additional areas of review concern the regulatory questions posed by new capital raising strategies, such as crowdfunding, and the scope of our existing rules that provide for capital raising, such as Regulation A.

The Commission looks forward to receiving the input of its recently formed Advisory Committee on Small and Emerging Companies.[2] Its members include representatives from a range of small and emerging companies, and investors in those types of companies, with real world experience under our rules. The advisory committee will provide a formal mechanism for the Commission to receive advice and recommendations about regulations that affect privately held and publicly traded small and emerging businesses. We look forward to working with the advisory committee and considering its views.

My testimony today will focus on small business capital formation initiatives and the broader capital formation regulatory review we are undertaking at Chairman Schapiro's request. I will also discuss the internal controls audit requirement under our rules.

Update on Review of Certain Offering Regulations

I would first like to provide an update on the staff's review of our regulations relating to the triggers for public reporting, the restrictions on general solicitation, and communications in connection with public offerings.

[2] *See SEC Announces Formation of Advisory Committee on Small and Emerging Companies* (Sept. 13, 2011), http://www.sec.gov/news/press/2011/2011-182.htm.

Triggers for Public Reporting

Chairman Schapiro has asked the staff to review the triggers for public reporting and the characteristics of companies that should be subject to public reporting obligations. In addition, bills have been proposed in both the House and the Senate relating to the Section 12(g) thresholds for reporting. (H.R. 1697, introduced by Representative Luetkemeyer; H.R. 1965, introduced by Representative Himes; and H.R. 2167, introduced by Representative Schweikert.)

Section 12(g) of the Exchange Act, which sets forth certain registration requirements for securities, was adopted in 1964 following a rigorous special study of the securities markets in the early 1960s, commissioned by Congress and conducted by the Commission.[3] The study included a survey of over 2,000 issuers that sought data from these issuers on, among other things, asset levels, their securities offerings, shares outstanding, stockholders of record, and the number of shares held by large shareholders. The data derived from the study was critical in developing the most appropriate metrics upon which to base the triggers for public reporting given the nature of the companies and the shareholders that would be impacted.

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[3] *Report of Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 88-95, pt. 3 (1963). According to the Committee Report summarizing the results of the study:

> There is no convincing reason why the comprehensive scheme of disclosure that affords effective protection to investors in the exchange markets should not also apply in the over-the-counter market. . . . [B]ecause the over-the-counter market includes not only securities of widely known and seasoned companies but also those of relatively unknown and insubstantial ones, the need of investors for accurate information is at least as great, if not greater than in the exchange markets.

S. Rep. No. 88-379, at 9 (1963).

Section 12(g) requires a company to register its securities with the Commission, within 120 days after the last day of its fiscal year, if, at the end of the fiscal year, the securities are "held of record" by 500 or more persons and the company has "total assets" exceeding $10 million.[4] Shortly after Congress adopted Section 12(g), the Commission adopted rules defining the terms "held of record" and "total assets."[5] The definition of "held of record" counts as holders of record only persons identified as owners on records of security holders maintained by the company, or on its behalf, in accordance with accepted practice. As such, this definition simplified the process of determining the applicability of Section 12(g).[6]

Of course, securities markets have changed significantly since the enactment of Section 12(g) and the Commission's adoption of the definition of "held of record." Today, the vast majority of securities of publicly-traded companies are held in nominee or "street name" rather than directly by the owner. This means that the brokers that purchase securities on behalf of investors typically are listed as the holders of record. One broker may own a large position in a company on behalf of thousands of beneficial owners, but because the shares are all held in street name, those shares count as being owned by one "holder of record." This change in the way securities are held means that for most publicly-traded

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[4] *See* Exchange Act § 12(g)(1); Exchange Act Rule 12g-1. When Section 12(g) was enacted, the asset threshold was set at $1 million. The asset threshold was most recently increased by rule to $10 million in 1996. Release No. 34-37157, *Relief from Reporting by Small Issuers* (May 1, 1996), http://www.sec.gov/rules/final/34-37157.txt.

[5] *See* Release No. 34-7492, *Adoption of Rules 12g5-1 and 12g5-2 Under the Securities Exchange Act of 1934* (January 5, 1965).

[6] *See id.*

companies, much of their individual shareholder base is not counted under the current definition of "held of record." Conversely, the shareholders of most private companies, who generally hold their shares directly, are counted as "holders of record" under the definition. This has required private companies that have more than $10 million in total assets and that cross the 500 record holder threshold – where the number of record holders is actually representative of the number of shareholders – to register and commence reporting. At the same time, it has allowed a number of public companies, many of whom likely have substantially more than 500 shareholders, to stop reporting, or "go dark," because there are fewer than 500 "holders of record" due to the fact that the public companies' shares are held in street name. In light of these issues, some have called for changes to the definition and threshold adopted pursuant to Section 12(g).

The Commission has exercised its exemptive authority in the past to adjust the application of Section 12(g).[7] For example, in 2007, the Commission adopted Rule 12h-1(f) under the Exchange Act, which provides an exemption from the held of record threshold for compensatory stock options. This exemptive rule allows private companies to provide compensatory stock options to employees, officers, directors, consultants and advisors without triggering the need to register those options under the Exchange Act.[8] A variety of

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[7] Exchange Act Section 12(h) provides the Commission broad authority to exempt issuers from the registration requirements of Section 12(g) so long as the Commission finds that the action is not inconsistent with the public interest or protection of investors. The Commission has previously relied on Section 12(h) to raise the total assets threshold. Additionally, Congress has provided the Commission broad exemptive authority in Section 36 of the Exchange Act. The Commission has previously established exemptions from the Section 12(g) requirement and Section 12(g) provides the Commission with authority to define the terms "held of record" and "total assets." *See* Exchange Act Rule 12g3-2 and Exchange Act § 12(g)(5).

[8] Release No. 34-56887, *Exemption of Compensatory Employee Stock Options from Registration Under Section 12(g) of the Securities Exchange Act of 1934* (December 3, 2007), http://www.sec.gov/rules/final/2007/34-

proponents have advanced a wide range of proposals relating to possible amendments to Section 12(g) reporting standards. Some of these proposals seek to reduce the number of issuers required to report pursuant to the Exchange Act, for example, by raising the shareholder threshold,[9] by excluding employees, or by excluding accredited investors, qualified institutional buyers ("QIBs") or other sophisticated investors from the calculation.[10] Conversely, the Commission has received a rulemaking petition requesting that the Commission revise the "held of record" definition to look through record holders to the underlying beneficial owners of securities that would prevent issuers from ceasing to report in certain circumstances.[11]

As stated, the securities markets have gone through profound changes since Congress added Section 12(g) to the Exchange Act. To facilitate the Commission's review of the issues related to the thresholds for public reporting (and those for leaving the reporting system), the staff is undertaking a robust study like the one conducted when Section 12(g)

56887.pdf. The staff of the Division of Corporation Finance also issued a no-action letter saying that it would not recommend an enforcement action to a company that issued restricted stock units due to the similarities between them and stock options. *See Twitter, Inc.* (September 13, 2011); *Zynga Inc.* (June 17, 2011); *Facebook, Inc.* (October 14, 2008).

[9] In a November 12, 2008 letter, the American Bankers Association made the argument that the 500-shareholder threshold should be increased to reduce the regulatory hardship suffered by small community banks. *See* Comment Letter from American Bankers Association to SEC (November 12, 2008), http://www.sec.gov/rules/petitions/4-483/4483-21.pdf.

[10] *See 2009 Annual SEC Government-Business Forum on Small Business Capital Formation Final Report* (May 2010), http://www.sec.gov/info/smallbus/gbfor28.pdf.

[11] On February 24, 2009, the Commission received a rulemaking petition urging the Commission to count beneficial owners instead of record holders to prevent companies with large numbers of holders from exiting the reporting system. *See* Petition from Lawrence Goldstein to SEC (February 24, 2009), http://www.sec.gov/rules/petitions/2009/petn4-483-add.pdf. This followed an earlier, similar petition. *See* Petition for Commission Action to Require Exchange Act Registration of Over-the-Counter Equity Securities (July 3, 2003), http://www.sec.gov/rules/petitions/petn4-483.htm.

was enacted. The study is seeking to determine whether the current thresholds and standards effectively implement the Exchange Act registration and reporting requirements and what it means to be a "public" company such that an issuer should be required to register its securities and file with the Commission. The staff has begun a detailed analysis of public company information – including numbers of record and beneficial owners, total assets, and public float – to assess the characteristics of public companies. The study also will seek to obtain and consider private company information to assess current reporting thresholds. To the extent that the staff develops recommendations or proposals regarding changes to the reporting thresholds for the Commission's consideration, the consequences of any such proposed change will be subject to careful assessment as to the impact on investor protection and capital formation and the other costs and benefits of any proposed change.

Restriction on General Solicitation

Chairman Schapiro also asked the staff to review the restrictions our rules impose on communications in private offerings, in particular the restrictions on general solicitation. In addition, a bill has been introduced by Representative McCarthy (H.R. 2940), which would require the Commission to revise its rules to permit general solicitation in offerings under Rule 506 of Regulation D.

One of the most commonly-used exemptions from the registration requirements of the Securities Act is Section 4(2), which exempts transactions by an issuer "not involving any public offering." Currently, an issuer seeking to rely on Section 4(2) is generally subject to a restriction on the use of general solicitation or advertising to attract investors for its offering.[12] The restriction was designed to protect those who would benefit from the safeguards of registration from being solicited in connection with a private offering.

The Commission and staff have acted to facilitate capital raising in private offerings by adopting safe harbor rules, such as Rule 506, and providing guidance with respect to the scope of Section 4(2) and the restriction on general solicitation and advertising. Recognizing the increased use of the Internet and other modern communication technologies in private offerings, the staff has issued no-action letters providing issuers with flexibility to use modern communication technologies without the staff recommending enforcement action regarding the general solicitation restriction.[13]

Notwithstanding these efforts, the restriction on general solicitation is cited by some as a significant impediment to capital raising.[14] We understand that some believe that the restriction may be unnecessary because offerees who might be located through a general solicitation but who do not purchase the security, either because they do not qualify under the

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[12] *See* Rule 502(c) of Regulation D and Release No. 4552, *Non-Public Offering Exemption*, (November 6, 1962).

[13] *See, e.g., IPONET* (July 26, 1996) (general solicitation is not present when previously unknown investors are invited to complete a web-based generic questionnaire and are provided access to private offerings via a password-protected website only if a broker-dealer makes a determination that the investor is accredited under Regulation D); *Lamp Technologies, Inc.* (May 29, 1998) (posting of information on a password-protected website about offerings by private investment pools, when access to the website is restricted to accredited investors, would not involve general solicitation or general advertising under Regulation D).

[14] *See, e.g., Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission* (April 23, 2006), http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf; Joseph McLaughlin, *How the SEC Stifles Investment – and Speech*, The Wall Street Journal (February 3, 2011). Concerns about the scope of the Commission's rules on general solicitation and advertising have been raised by the participants in the annual SEC Government-Business Forum on Small Business Capital Formation. *See 2009 Annual SEC Government-Business Forum on Small Business Capital Formation Final Report* (May 2010), http://www.sec.gov/info/smallbus/gbfor28.pdf.

terms of the exemption or because they choose not to purchase, would not be harmed by the solicitation.[15] In addition, some have questioned the continued practical viability of the restriction in its current form given the presence of the Internet and widespread use of electronic communications. At the same time, others support the restriction on general solicitation on the grounds that it helps prevent securities fraud by, for example, making it more difficult for fraudsters to find potential victims or unscrupulous issuers to condition the market.[16]

We believe it is important to consider both of these views about the need for the restriction on general solicitation in private offerings when considering possible revisions to our rules. In analyzing whether to recommend changes to the restriction, the staff is considering next steps, including a possible concept release for the Commission to seek the public's input on the advisability and the costs and benefits of retaining or relaxing the restrictions on general solicitation. The Commission could seek views from all interested parties on a number of issues related to the restriction on general solicitation, including specific protections that could be considered if the restriction is relaxed and the types of investors who would be most vulnerable if it is relaxed. The staff also will seek input from the Advisory Committee on Small and Emerging Companies. Of course, in considering

[15] *See Pinter v. Dahl*, 486 U.S. 622, 644 (1988) ("The purchase requirement clearly confines §12 liability to those situations in which a sale has taken place. Thus, a prospective buyer has no recourse against a person who touts unregistered securities to him if he does not purchase the securities.").

[16] *See, e.g.*, J. William Hicks, Exempted Transactions Under the Securities Act of 1933 § 7:160 (2d ed. 2002); Comment Letter from Investment Companies Institute to SEC (October 9, 2007), http://www.sec.gov/comments/s7-18-07/s71807-37.pdf (warning that unlimited general solicitation would "make it difficult for investors to distinguish between advertisements for legitimate offerings and advertisements for fraudulent schemes").

whether to recommend that the Commission make changes to the rules restricting general solicitation, we will remain cognizant of our investor protection mandate.

Communications in Public Offerings

We also are assessing our rules, and the regulatory burdens they impose, with respect to communication in public offerings. Over the years, the Commission has taken steps to facilitate continued communications around public offerings. For example, as early as 1970, the Commission adopted safe-harbor exemptions to make it clear that continued analyst research coverage does not constitute an unlawful offer.[17] In 2005, the Commission significantly reformed the registration and offering process by adopting a comprehensive set of rules and amendments to facilitate capital raising and relax restrictions on communications by issuers during the registered offering process.[18] These changes significantly liberalized the rules governing communications by the largest issuers during public offerings, thereby allowing more information to reach investors. The staff is reviewing the rules relating to communications in public offerings to consider whether any of the liberalizations adopted in 2005 should be adapted for smaller public companies, including whether more companies should be able to use free writing prospectuses before a substantially complete prospectus is filed. As a result of this review, the staff may recommend proposed changes to the offering

[17] *See* Release No. 33-5101, *Adoption of Rules Relating to Publication of Information and Delivery of Prospectus by Broker-Dealers Prior to or After the Filing of a Registration Statement Under the Securities Act of 1933* (November 19, 1970).

[18] *See* Release No. 33-8591, *Securities Offering Reform* (July 19, 2005), http://www.sec.gov/rules/final/33-8591.pdf.

rules, or recommend that the Commission seek additional input through the issuance of a concept release.

As part of its review, the staff also is considering regulatory questions posed by new capital raising strategies, such as crowdfunding, and the scope of our existing rules that provide for capital raising, such as Regulation A.

Crowdfunding – A New Capital Raising Strategy

A new method of capital raising that is gaining increasing interest is crowdfunding. Generally, the term "crowdfunding" is used to describe a form of capital raising whereby groups of people pool money, typically comprised of very small individual contributions, to support an effort by others to accomplish a specific goal. This funding strategy was initially developed to fund such things as films, books, music recordings, and charitable endeavors. At that time, the individuals providing the funding were more akin to contributors than "investors" and were either simply donating funds or were offered a "perk," such as a copy of the related book. As these capital raising strategies did not provide an opportunity for profit participation, initial crowdfunding efforts did not raise issues under the federal securities laws.

Interest in crowdfunding as a capital raising strategy that could offer investors an ownership interest in a developing business is growing. A bill has been introduced by Representative McHenry (H.R. 2930) that would provide an exemption from Securities Act registration for securities sold in crowdfunding transactions that meet specified requirements.

Proponents of crowdfunding are advocating for exemptions from the Securities Act registration requirements for this type of capital raising activity in an effort to assist early stage companies and small businesses. For example, the Commission received a rulemaking petition requesting that the Commission create an exemption from the Securities Act registration requirements for offerings with a $100,000 maximum offering amount that would permit individuals to invest up to a maximum of $100.[19]

The staff has been discussing crowdfunding, among other capital raising strategies, with business owners, representatives of small business industry organizations, and state regulators. For example, crowdfunding was discussed at the Commission's November 2010 Forum on Small Business Capital Formation. In January, the staff met with a group from the Small Business & Entrepreneurship Council advocating an exemption from registration requirements for crowdfunding offerings meeting specific requirements. In addition, in March the staff discussed crowdfunding with representatives from the North American Securities Administrators Association, the organization of state securities regulators.

Current technology allows small business owners to easily access a large number of possible investors across the country and throughout the world as a source of funding to help grow and develop their businesses or ideas. This source of capital and the ease with which an individual can communicate with and access investors electronically presents an opportunity for smaller companies in need of funds.

[19] Petition from Sustainable Economies Law Center to SEC (July 1, 2010), http://www.sec.gov/rules/petitions/2010/petn4-605.pdf. To date, the petition has received almost 150 comment letters, all in favor of the creation of such an exemption, with some offering different thresholds for offering size and/or individual investment limits. The comment letters are available at http://www.sec.gov/comments/4-605/4-605.shtml.

At the same time, of course, an exemption from registration and the investor protections provided thereby also would present an enticing opportunity for the unscrupulous to engage in fraudulent activities that could undermine investor confidence.[20] As a result, in considering whether to provide an exemption from the Securities Act registration requirements for capital raising strategies like crowdfunding, the Commission needs to be mindful of its responsibilities both to facilitate capital formation and protect investors.

The Commission's rules previously included an exemption, Rule 504, which allowed a public offering to investors (including non-accredited investors) for securities offerings of up to $1 million, with no prescribed disclosures and no limitations on resales of the securities sold.[21] These offerings were subject only to state blue sky regulation and the antifraud and other civil liability provisions of the federal securities laws. In 1999, that exemption was significantly revised due in part to investor protection concerns about fraud in the market in connection with offerings conducted pursuant to this exemption.[22] In assessing any possible exemption for crowdfunding, it would be important to consider this experience and build in investor protections to address the issues created under the prior exemption.

Some of the questions to consider with regard to crowdfunding include:

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[20] Note that the antifraud provisions of the federal securities laws continue to apply to any offering or sale of securities, even if an exemption from registration applies. In Fiscal Year 2010, offering frauds – cases where promoters, issuers or others defraud investors in the offer of securities – comprised 22 percent of the Commission's cases.

[21] *See* Release No. 33-6949, *Small Business Initiatives* (July 30, 1992), http://www.sec.gov/rules/final/6949.txt.

[22] *See* Release No. 33-7644, *Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption* (February 25, 1999), http://www.sec.gov/rules/final/33-7644.txt (referencing "disturbing developments" in, among other things, initial Rule 504 issuances).

- what information – for example, about the business, the planned use of funds raised, and the principals, agents, and finders involved with the business – should be required to be available to investors;

- what restrictions should there be on participation by individuals or firms that have been convicted or sanctioned in connection with prior securities fraud;

- should a Commission filing or notice be required so that activities in these offerings could be observed;

- should securities purchased be freely tradable; and

- should websites that facilitate crowdfunding investing be subject to regulatory oversight?

Although the business venture may have a well-formulated plan and a committed entrepreneur, potential investors may have little information about the plan, its execution, or the entrepreneur behind the business. Investments in small businesses can be open to opportunism created by this information asymmetry. Sophisticated investors generally negotiate protections for themselves and may provide their funding over time to protect their investment, but due to the nature of crowdfunding ventures, crowdfunding investors may have limited investment experience, limited information upon which to make investment decisions, and almost no ability to negotiate for protections. While the small amount of any potential crowdfunding investment may limit the extent of any individual's losses, these issues are among those that would need to be considered as a part of the cost-benefit analysis that the Commission would consider in connection with any future proposal.

As mentioned, the staff is reviewing crowdfunding and other capital raising strategies at Chairman Schapiro's request. The Chairman also has stated that the Commission's recently formed Advisory Committee on Small and Emerging Companies will be asked to assess these issues. We fully expect that the input from the advisory committee, as well as the input we receive from the public, will be helpful to the Commission as it considers these matters.

Potential Increase in Offering Amount Permitted under Regulation A

Regulation A under the Securities Act provides an exemption from registration for transactions by non-reporting companies of up to $5 million per year. The exemption requires an offering document to be filed with the SEC, which is subject to SEC staff review. The exemption sets forth information requirements that are simpler than those required in registered offerings, including allowing companies to provide the disclosure in a question and answer format, and allows companies to "test the waters" for interest in their offerings before they incur the full expense of preparing the Regulation A offering document. Unlike the private placement exemption, the Regulation A exemption permits a public offering that is not limited to particular types of investors, and the securities purchased are not transfer-restricted under the Securities Act. Unlike registered offerings, companies that complete Regulation A offerings do not automatically become subject to ongoing reporting under the Exchange Act. Instead, reporting would be required only if the company has a class of securities listed on a national securities exchange or the company reaches the thresholds under Section 12(g) that require registration under the Exchange Act. Offerings conducted in reliance on Regulation A are not preempted from state registration under Section 18 of the

Securities Act, and, thus, are subject to compliance with state securities laws in the states in which the company offers or sells the securities.

Regulation A is not widely used. For example, in the fiscal year ended September 30, 2010, there were 25 initial Regulation A filings with the Commission and only seven Regulation A offerings were qualified. Some have indicated that the $5 million annual cap reduces the utility of the Regulation A exemption and have advocated for an increase. The Regulation A offering limit was last raised in 1992, when it was increased from $1.5 million to $5 million.[23] Bills have been introduced in both the Senate and the House that would require the Commission to create a new exemption, which would be similar to Regulation A, but with certain additional conditions and a higher offering limit. (H.R.1070, introduced by Representative Schweikert.)

The ongoing review of the impact of our regulations on small business capital formation will include consideration of whether the Regulation A ceiling should be raised, including whether raising the ceiling would promote increased reliance on the exemption in a manner consistent with investor protection, and whether there are other impediments to use of the exemption that could be addressed by the Commission. In this connection, the staff plans to solicit the views of its Advisory Committee on Small and Emerging Companies.

[23] Regulation A was promulgated pursuant to Section 3(b) of the Securities Act, which allows the Commission to adopt rules exempting certain offerings, up to $5 million, if the Commission finds that "enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering…."

Sarbanes-Oxley Section 404

In order to address concerns about the costs for smaller companies of the internal controls over financial reporting attestation requirements of Section 404 of the Sarbanes-Oxley Act, in 2010 Congress adopted Section 989G of the Dodd-Frank Act. That section amends the Section 404 requirements to provide that smaller companies (specifically those that are not "accelerated filers" or "large accelerated filers" under our rules) are exempted from the requirement in Section 404(b) that an independent auditor attest to, and report on, the issuer's assessment of its internal controls. As a result, more than 60% of companies filing reports with the Commission – those with the smallest public float – are now exempt from the internal controls audit requirement.[24]

The staff encourages activities that have the potential to further improve both the effectiveness and the efficiency of the evaluation of internal controls, while maintaining important investor protection safeguards. For example, with this objective in mind, the staff continues to work with the PCAOB to monitor inspection results and assess the extent to which publishing observations can be useful. The staff is also observing COSO's (Committee of Sponsoring Organizations of the Treadway Commission) project to review and update its internal control framework, which is the most common framework used by management and auditors alike in performing assessments of internal control over financial reporting.

[24] Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between $75 and $250 Million (April 2011). http://www.sec.gov/news/studies/2011/404bfloat-study.pdf. This study was required pursuant to section 989G(b) of the Dodd-Frank Act. The GAO is required to conduct a study of the impact of the exemption provided by Section 989G(a), which is due three years after enactment of the Dodd-Frank Act.

In Congress, draft legislation has been proposed by Representative Fincher that would further amend the Section 404 internal controls audit requirement with regard to certain classes of issuers.

Conclusion

In considering possible revisions to the Commission's rules, it is critically important that the staff gather data and seek input from a wide variety of sources, including small businesses, investor groups, and other members of the public. The data and input the staff receives should aid in the development of thoughtful recommendations for the Commission consistent with the goals of facilitating capital formation and protecting investors.

Thank you again for inviting us to appear before you today. We would be happy to answer any questions you may have.

Written Testimony of Dana Mauriello, Co-Founder and President of ProFounder, to the Subcommittee on Capital Markets and Government Sponsored Enterprise

"Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation"

SEPTEMBER 21, 2011

Good afternoon Chairman Garrett, Ranking Member Waters and members of the subcommittee. My name is Dana Mauriello. I am the Co-founder and President of ProFounder, which is an online platform for entrepreneurs to raise investment capital from their communities. In your invitation letter, you asked me to address specific actions that the SEC can pursue to facilitate capital formation, including HR 1965, HR 2167, HR 2930, HR 2940, and the Small Company Job Growth and Regulatory Relief Act of 2011. Given my specific experience and expertise in the crowdfunding space, I will focus my testimony on HR 2930. I am grateful for the opportunity to present my views this morning.

First, I will provide an overview of the current crowdfunding landscape and provide my views on why crowdfunding is a critical tool for capital formation. Second, I will describe ProFounder, including its legal framework and features as well as the challenges that we faced in creating a crowdfunding product while remaining compliant with current regulation. Finally, I will suggest regulatory changes, based on the HR 2930 framework, that should be made to facilitate crowdfunding while also maintaining a high level of investor protection.

I had the privilege of testifying on September 15, 2011 at the "Crowdfunding: Connecting Investors And Job Creators" Hearing held by the Committee on Oversight and Government Reform U.S. House of Representatives, Sub-Committee on TARP and Financial Services. While the bulk of my written testimony is the same, I have updated my thoughts on suggested regulatory change now that I have had the opportunity to see HR 2930 and gain a more thorough understanding of the full potential seen by its supporters and the investor protection fears voiced by its critics.

My Background and the ProFounder History

I started ProFounder with Jessica Jackley in August 2009 out of a desire to give entrepreneurs access to the resources that they need to succeed. I was first exposed to entrepreneurship through my experience with my family's businesses. My father taught me early on that there is no problem you can't solve with ingenuity and hard work--a mantra that I consider to be at the very core of the American entrepreneurial spirit. In first grade, I found that when I tried to rip pages out of my workbooks they came out torn and messy, so I invented a "Page Helper" to solve this problem and my family helped me to produce them and create a business plan. That was my start and from there, I had the opportunity to be involved with the numerous business ventures that arose from dinnertime conversation and basement tinkering -- from exercise equipment to baked goods manufacturing. The first bit of start-up capital always came from Uncles, Aunts, and friends who believed in us and what we were doing. Our story is one that I now know is repeated across dinner tables and basements the country over.

While attending the Stanford Graduate School of Business, I met my now-co-founder, Jessica Jackley, and we started a dialogue about how to bring entrepreneurial resources to small business entrepreneurs far from Silicon Valley. Jessica also founded KIVA, the first peer- to- peer microfinance site in 2005. KIVA is widely recognized as a pioneering financial technology organization and has facilitated over $241 million in loans to entrepreneurs in 216 countries including the United States.

The idea for ProFounder came to us when we saw two classmates who were starting a business get investment interest from dozens of fellow classmates. When these entrepreneurs asked their lawyers to structure this investment deal, they were told that it is impossible for their classmates to invest even $1K each because they are unaccredited investors. When pushed, the lawyers spent months and tens of thousands of dollars to structure a deal that would include only 35 of these classmates. We were struck by the incredible inefficiency of this arrangement; available capital existed in the community, but there were tremendous legal and administrative barriers to accessing it.

Jessica and I started ProFounder to solve this market inefficiency and make it possible for entrepreneurs to unlock the capital in their communities. We called this method of financing "community funding," and created a platform that allowed entrepreneurs to utilize their social networks for investment capital in a way that is be simple, inexpensive, efficient, and legally compliant for all involved.

We chose to focus our efforts on supporting small businesses in America because we feel that these businesses have the most limited resources, but limitless ideas and potential to create innovation and economic value.

To date we have enabled 19 companies to complete 21 fundraising rounds for a total of over $612K raised from 356 investors. Our success cases include entrepreneurs like Bronson who raised $56K from 19 classmates, customers, family, and friends to expand his family's candy shop in Hawaii and Raaja who raised $60K from 37 classmates, friends, and family to start a now-thriving sneaker business.

The Crowdfunding Option

a) Definitions and Landscape

Crowdfunding refers to the process of many people contributing small dollar amounts which, in aggregate, meet the financial goal of a project. In this section, I will outline the services that the most influential technology companies in this industry provide, and the legal frameworks that they employ. Note that crowdfunding also happens infrequently offline through Reg D, Reg A, and co-op structures and I am not considering those offline pathways in this overview.

KIVA, founded in 2005 by my co-founder, Jessica Jackley, was the first peer-to-peer lending site. KIVA provides an online marketplace where microfinance institutions can list businesses from their portfolios seeking loans, and individuals can contribute to the loan in $25 increments with the intention that they will be repaid their principal with no interest. Loans made on the site are not considered securities because there is no financial upside for the lender and KIVA is a non-profit that does not profit from the transactions. Prosper, also a peer-to-peer lending site, facilitates personal loans to individuals that are repaid at a fixed rate of interest. The loan products on Prosper (unlike on KIVA) are registered securities.

IndieGoGo (www.indiegogo.com), launched in 2008, provides a marketplace where donors offer capital and receive goods and services in return. An example of a typical project on IndieGoGo might be an author raising $5K to self-publish his book, asking for individuals to contribute $25 toward his goal to receive a signed copy of the book in return. Kickstarter (www.kickstarter.com) and almost 200 other sites have since launched to provide similar services. Kickstarter, IndieGoGo, and others do not facilitate investments; the capital contributed is not an investment, will not generate financial return, and will not generate a non-financial return that is dynamic depending on the success of the business. To avoid falling under the purview of state and federal securities regulators, these sites ensure that the reward for a financial contribution is limited to a good or service with a fixed value or to nothing at all.

Note that none of these crowdfunding sites allow for businesses to offer investments / transact securities. This biggest hurdle that prevents them from doing so is the prohibition of general solicitation. To a lesser degree, these sites are also thwarted by other regulatory hurdles such as: the restrictions on the involvement of unaccredited investors (Reg D 506), limits on the number of investors who can be involved in an offering (Reg D), extensive disclosure requirements (Reg A), state-by-state blue sky laws (Reg D 504), and requirements for broker dealer registration.

The last notable addition to the crowdfunding landscape is Angel List (http://angel.co/), launched in 2010 to connect accredited investors with start-ups looking for capital. They gained notoriety because of their careful curation of deals and the social validation tools that they employ to keep the network of investors and entrepreneurs very high caliber. I consider Angel List a crowdfunding innovation because it is an online platform that connects both sides of the financial marketplace. They have navigated legal barriers by only working with accredited investors, not advertising deal terms, and not charging any fees.

b) Why crowdfunding matters

It is important that crowdfunding exist because it democratizes access to start-up capital. Capital exists in people's communities and it just can't be accessed. Anyone who is bright, driven, and has a great idea can gather a supportive community around himself. Crowdfunding allows that entrepreneur to turn his community into a capital source.

Businesses that do not qualify for bank loans can get capital via crowdfunding because the crowd is using different decision making criteria than the bank. Whereas a bank looks at collateral and balance sheets, the community makes a decision based on personal knowledge of the entrepreneur's character and their affinity for her product. In addition to different decision making criteria, definitions of success are also very different for either party. Whereas banks evaluate the success of a loan solely on full, timely repayment at the market interest rate, the community may consider an investment successful if they recoup their principal, feel the pride of being a part of something, and get exclusive perks. For example, community members invest in local restaurants, not to get rich, but to be able to tell their friends that they are investors and ensure that their corner table is always waiting for them with their favorite drink on the house.

Similarly, business that can't access angel capital are often successful with the crowd. Angel investors are usually geographically focused (major metropolitan areas) and industry focused (technology). For the entrepreneur starting a vegan bakery outside of DeMoines, her options for angel capital are slim to none as neither the geography nor the industry is a typical fit. However, she is more likely to find success in raising capital from vegan neighbors in her DeMoines suburb who are eager to patronize her new establishment once it opens. This is a classic example of fan dynamics.

Crowdfunding is not a last resort, it is a strategic choice. For example, Marc raised $50K for his motorcycle business from 16 investors in his community via ProFounder and by pursuing this funding path, Mark could include motorcycle enthusiasts among his investors. These investors could provide tremendous signaling value to future investors and customers and help with marketing by using his bikes at high profile events.

Crowdfunding programs that center around community investment also have strong, inherent investor protection. If an entrepreneur's community invests in her, the repetitional consequences of her defrauding them are very strong. For example, Jared raised $41K from 17 investors via ProFounder to open Fargo Brewing Company. If Jared ran with that money, many of his relationships would be ruined and his reputation would be so decimated that he'd never be able to show his face in Fargo again. On the other hand, if Jared was unscrupulous and he obtained funding from an anonymous institution across the country, he would have relatively weak incentives to repay and absolutely no incentive to exercise generosity above what is required of him.

Crowdfunding keeps money within communities, making the entire community richer and more economically stable. This applies to physical communities and ideological communities alike. For example, if I invest in my local deli, I am very likely to also contribute to increasing their revenue by eating there more often and telling my friends to eat there as well. When the deli does well, I can use my gains to then also invest in the local nail salon. The successful deli will also spend more money in the community, hiring new employees and contracting with the local printer. Another example: I invest in another woman owned business because I want to support women entrepreneurs. When the venture succeeds, I get a financial reward and my capital gains buoy the aggregate economic success of my community of women. The entrepreneur that I invested in now has money (and inspiration) to make an investment of her own in another women-led business and continue the cycle that I began.

The ProFounder Solution

a) Legal Structure

When Jessica and I created ProFounder, our aim was to create a solution for entrepreneurs to effectively and efficiently access capital from their communities. Our biggest hurdle was navigating a very complex legal environment and we spent a year working with numerous law firms, partners, and supporters to find an appropriate legal framework to meet our goals. The first conclusion that we reached was that it is important that entrepreneurs be able to offer their investors a financial return. We felt that this was the fairest arrangement that honored the risk that investors would be taking on the venture. We also felt that a financial return was particularly important to offer given the significant individual investment amounts that we anticipated would be necessary to meet the high ($50K+) investment goals on our platform. Offering a financial return makes the investment contract a security. Finally, we realized that entrepreneurs did not have the time or resources to register their securities offering, so finding an appropriate exemption from registration was necessary. We eliminated Regulation A because we felt that the disclosures and pre-filing were too onerous to be feasible for small businesses. We also got feedback from state regulatory bodies that Reg A offerings are so rare that the required pre-approval in each state is lengthy and onerous. We instead identified Regulation D, Rule 504 as an appropriate solution for our entrepreneurs because

- Most small businesses need less than $1M in financing
- We wanted to be able to include any potential investor; including those who are unaccredited/ unsophisticated.
- The investors who are most likely to invest in a small business are those who know the entrepreneur; in other words those who share a "substantial, pre-existing relationship" with the entrepreneur
- Blue sky laws can be easily deciphered and automated with technology

We later choose to offer a Regulation D, Rule 506 compliance structure as well.

b) Product Features

With this regulatory structure in mind, we created an online platform that had the following features for entrepreneurs:

1. Prepare for Investment

Plan investor outreach and see relevant compliance implications for your investor pool (unaccredited investors from all 50 states). Chose between basic (504) and enhanced (506) compliance engines. Our site takes into account dynamic state-by-state interactions caused by blue sky laws.

2. Create your Pitch
   Simple, interview-style pitch creation process for a simple, clear, transparent end product that can be shared to ensure that investors are fully informed and knowledgable about the offering.
3. Create your Offer Terms
   Customize revenue- share or equity term sheet templates.
4. Publish your Fundraising Website
   Pitch and term sheet are presented together in a private fundraising website created for your business
5. Invite your Community to Invest
   Send emails to your community through the ProFounder app inviting them to view your private fundraising website, keep a record of emails sent, and see analytics on their impact. All invitations sent contain a unique link created exclusively for the recipient of the email that can not be forwarded or shared. Compliance is further ensured by requiring that all issuers confirm that they have a substantial, pre-existing relationship with the issuer before being able to view the offering.
6. Receive Pledges for Funding from Investors Directly on your Website
   Investors can pledge an investment electronically on your fundraising website
7. Manage the Collection of Funds
   Disseminate information about how to send funds and track incoming cash
8. Sign all Investment Documents Electronically
   E-signatures of term sheets and related documents for you and your investors
9. Receive Compliance Information
   Get information on necessary filling documents and fees to be submitted after you receive your funds
10. Manage Payments to Investors
    Calculate payouts due to investors per your investment contract/ term sheet

We monetized our services by (1) charging entrepreneurs a flat fee of $100 to publish their fundraising page and (2) charging entrepreneurs a flat fee of $1000 to service their contracts. Servicing a contract involved generating an investment contract that was customized by each entrepreneur, facilitating e-signatures of the term sheets, and document storage among other basic administrative services. We made the choice not to charge commissions or otherwise involve ourselves directly in the transaction to steer clear of Broker Dealer registration and responsibilities.

We began serving entrepreneurs in September of 2010 with a small, private pilot and launch publicly in December 2010. Since that time we have enabled 19 companies to complete 21 fundraising rounds for a total of over $612K raised. These companies engaged a total of 356 investors in their fundraising. The average raise size was $29K, the average investment per investor was $1,700 and the average number of investors per raise was 17.

At its peak in May 2011, our business employed 8 full time employees, 1 part time employee, and a variety of contractors.

c) Challenges Faced

- Broker Dealer Issues: We were approached by the California Department of Corporations in February 2011 to provide more information on the legal structure of our business. Conversations continued in a productive manner for a number of months, until June 2011 when the DOC determined that we needed to have a broker dealer license to continue to facilitate the transaction of securities online. This determination was based on the assertion that we were engaged in the negotiation of deals given that we provided templates for term sheets that entrepreneurs could customize and take advantage of, had at one time been involved in handling customer funds, and provided automated legal compliance support. We decided to enter into a consent agreement with the DOC, not pursue a Broker Dealer license, and remove the feature on our site that allowed for securities to be transacted (ie, publishing a private fundraising site, invite investors, and accepting pledges online). Our product still meets the same need of facilitating community-funding, the difference is that it is now a free DIY tool kit.
- Lack of Clear Definitions: Our compliance structured relied on restrictions around general solicitation, sophisticated investors, and investors with whom the entrepreneurs has a substantial pre-existing relationship. Unfortunately, none of these terms has a clear definition, so these concepts were challenging to implement in practice and we had to error on the side of excess caution in the face of ambiguity. Even at that, the entrepreneurs using our platform, and especially their lawyers, were hesitant about employing a structure that engaged these under-defined concepts and often felt more comfortable sticking to more traditional solutions (ie, accredited investors only).

Suggested Regulatory Changes

I am very cognizant of the risks involved in opening the opportunity to invest in unregistered securities offered by private companies to the general public and I respect the caution that is being exercised around this issue. Below I outline the key features of a regulatory change that would enable entrepreneurs to raise investment capital from their communities while taking precautions to protect investors and prevent fraud, using HR 2930 as a starting point.

HR 2930: Key points from the existing bill

1. No shareholder limit

I propose allowing an unlimited number of investors into crowdfunding deals to keep deals as simple as possible, allow for the full advantages of general solicitation to be realized, and unfetter entrepreneur's potential. That said, the exact number of shareholders that is allowed is not the most critical element of this bill; I believe that after a certain number, say 500 or 1000, allowing for more investors offers diminishing returns to the entrepreneur. In the small businesses fundraising activities that we have coordinated, we have found that there is a natural limit to the number of investors that an entrepreneur can include based on the sheer human effort required to make the sales (effort which we have found that technology cannot eliminate). This natural limit also arises because many entrepreneurs are cognizant about not including so many shareholders that future investors are turned off from participating. Since, as we learned, people want to invest personally meaningful amounts ($1700 on average per investor via ProFounder), thousands of investors are not necessary to achieve most financial goals.

2. General solicitation Allowable

General solicitation is currently defined as seeking interest from the general public for an offering through mass communication and this is prohibited for all unregistered securities offerings. The spirit of this law is to ensure that false claims about an offering can not be spread to unknowing potential investors. However, given its current definition, general solicitation serves to create unreasonable barriers for businesses to share information about an offering with even a close community of potential purchasers. A more balanced definition of general solicitation would state that issuers can publicly advertise offerings with appropriate disclosures, given that the opportunity to purchase the securities is only open to qualified purchasers (described below).

3. Limit Investment Amounts

The amount that any individual investors can invest in securities organized through this exemption annually should be limited to 5% or less of his or her liquid investable assets. I understand that HR 2930 proposes setting this limit as the lesser of 10% of net income or $10K. While this would be sufficient for the majority of cases, I see no reason to limit the specific dollar amount as it is meaningless if not stated in relative terms to an individual's net worth. It is also clear from other securities regulation (for example, the definition of an accredited investor) that fixed dollar limits quickly become outdated.

4. Limit Total Raise Amount
The dollar amount that an entrepreneur can raise annually using this exemption should be limited to $1M and it should be permissible to combine this exemption simultaneously with any combination of others (for example, with Reg D, Rule 506 which is most commonly used in angel investing) for an unlimited aggregate dollar amount. I believe that the crowdfunding exemption will be most often utilized for providing the first capital in the door for a business and will serve as a gateway for businesses to raise larger rounds of growth capital from traditional sources down the road. That said, it is imperative that use of this exemption does not inhibit future rounds of funding and the two fundraising events can be treated completely independently from a regulatory perspective. I believe that the vast majority of entrepreneurs who can utilize this crowdfunding exemption will have needs below $1M. As a point of reference, the average dollar amount that a business wants to raise on ProFounder is $30K. SBA- backed small business micro-loans center around $75K and the average start-up capital invested in Inc 500 companies is around $75K as well. I understand that HR 2930 proposes a $5M limit and while I would love to support this higher ceiling and the greater potential that it could unleash, given that I think there will be relatively few of these larger deals compared to the sub $1M deals, I don't think it's worth the trade- off of increased fraud risk and the obligations of investor protection that may be imposed on the platform as a result.
5. Self Verification of Income - HR2930 also proposes that the income of the purchaser be self-verified for the purposes of the income test described in point 3 above. I whole heartedly support this provision and think that it's wise to include. The alternative is that the crowdfunding platform would need to independently verify income and this would greatly diminish efficiency and therefore limit the number of deals that a platform could reasonably facilitate.

Beyond HR 2930: Necessary pre-conditions for new businesses to be started that will facilitate these crowdfunding transactions

1. National Pre-Emption
Federal law should trump state law in this new regulatory area, for simplicity of compliance and so that solution can be standardized. Only once the process is standardizable, can online platforms be created to facilitate this process in a scalable way. And only once this process is scalable can these business facilitate a high volume of small deals for the mass small business market.
2. No Broker-Dealer Requirements

Currently, any platform that facilities the transaction of securities is required to obtain a Broker Dealer license. This is overly restrictive for start-ups wanting to facilitate crowdfunding. The rule change should include a clause stating that if the facilitating entity does not endorse deals, it does not require licensing. Below, I propose an alternative set of self-regulatory procedures below that I believe the industry should adhere to which are inspired by and adapted from the FINRA rulebook. This is a critical component of any new legislation because the broker dealer requirement creates a massive barrier to entry for new businesses looking to innovate in this industry. While that hurdle is surmountable, most importantly, broker dealers are required to conduct extensive due diligence on issuers and purchasers and, due to this expense, it is cost prohibitive for them to facilitate the offerings of small businesses looking for minimal dollar amounts. While a $100K deal might be meaningless to a typical Broker Dealer, that is the size of the deals that have the ability to really jump start new business creation, jobs, and economic growth. Speaking from personal experience, we have approached numerous Broker Dealer partners and are consistently turned down for partnership because our deals are too small. In the words of one potential BD partner: "From a purely business standpoint the fact that [we, the BD] would be allowing ProFounder to be licensed reps also adds to the complexity as we would be solely responsible for the due diligence of each and every deal going forward regardless of whether the deals are offered to just friends and family of ProFounder issuers or that the deals themselves are very small." Crowdfunding is a very unique type of securities sale and the Broker Dealer requirements absolutely must be flexible to account for that.

Beyond HR 2930: Maximizing Investor protection

1. Qualified Purchasers

While I am proposing that issuers be able to general solicit by sharing offering information, I would like to balance that with investors protection pertaining to who is qualified to purchase said securities. Specifically, I can identify three groups of individuals who should be able to purchase because they will be most well informed and able to make an educated decision about the opportunity: those who are sophisticated, those who know the entrepreneur, and those who are local to the (bricks and mortar) business.

a) "Sophistication" - Sophisticated investors are defined as those individuals who are sufficiently knowledgeable with respect to financial matters such that they can fend for themselves in the purchase of securities and do not require the full protection of securities law (http://www.sec.gov/info/smallbus/qasbsec.htm). This definition currently comes into play in Regulation D, Rule 506, which states that up to 35 "sophisticated" investors can participate in a fundraising event. The spirit of this law is to acknowledge that some investors are educated/ experienced enough to make their own investment decision regardless of their personal wealth level. Unfortunately, the definition is very vague and difficult to use in practice. As a result, lawyers frequently choose to ignore the sophisticated investor exemption of Regulation D, Rule 506 and insist that their clients only include accredited investors when fundraising. A more effective alternative would be a standard questionnaire to determine that someone is a sophisticated investor. Once defined more clearly, any sophisticated investor should be able to participate in an offering through this proposed crowdfunding exemption. One potential use case for this provision is young alumni who are educated, but not yet wealthy, investing in student businesses from their alma mater.

b) Personal Relationship - Anyone who has a personal relationship with the business owner should be allowed to invest in the offering. Under Regulation D, Rule 504, business owners can engage unaccredited/ unsophisticated investors to invest so long as they share a "substantial, pre-existing relationship." The spirit of this law is that people who have an intimate, personal knowledge of your finances, and you of theirs, should be able to invest based on this knowledge regardless of their wealth or financial expertise. An updated version of this "personal relationship" provision would state that anyone who can certify that they have a personal relationship with the entrepreneur and can confidently speak to his or her character and business acumen can invest and the "pre-existing" portion of the definition would be eliminated. This is adequately broad such to allow entrepreneurs to tap into their online social networks and request introductions to friends-of-friends.

c) Local Investors - Anyone who lives within 100 miles of the business (bricks and mortar location) should also be able to invest based on the premise that they can do appropriate due diligence by visiting the business, verifying that it exists, testing its product, and seeing its traffic. This provision is inspired by Rule 147, an intra-state offering exemption available to local businesses that do nearly all of their trade within the state and are looking to include only investors within the state.

2. Issuer Disclosures

It is appropriate and necessary to require a limited, concise set of disclosures to be shared with potential purchasers. Specially, I see a place for an abridged balance sheet of historical and forward looking financials, risk factors, and an explanation of forecasts. Striking a balance is imperative here; if disclosures are too extensive, time consuming, or confusing to new businesses, then this exemption will never be utilized.

3. Notice Filings

I feel that it is appropriate for the issuer to submit a notice filling (in the fashion of Form D for all Reg D offerings) so that all securities are properly documented and accounted for in case of fraud. If nominal fees are necessary to support governmental administrative costs, this would be a minimal hurdle and is not something that I would object to.

4. Industry Self-Regulation

The Crowdfunding industry should adopt a set of self-regulatory procedures as another step to prevent fraud from occurring on their platforms. A complete list of practices would require input and buy-in from all of the major players in the industry, but in an effort to provide expedient feedback for this testimony, I drafted the list below of what these practices could look like based on my personal thoughts. In creating this list, I drew heavily from the FINRA Rulebook and attempted to maintain the spirit of those rules while adapting and modeling them to be a better fit for this industry. I also drew from previous interviews with the Prosper.com team about the anti-fraud procedures that they employ and credit them with points i, j, and k.

a) Transparent Group Rules & Membership- The Crowdfunding industry should form a self-regulating group and make their practices and membership list transparent to the public.

b) No Endorsements - My interpretation of the FINRA rulebook is that the majority of compliance imposed on Broker Dealers is invoked because these individuals endorse particular securities to their clients and therefore need to have sufficient education, client information, and disclosures to provide fair and accurate advice. I recommend that Crowdfunding platforms taking advantage of HR 2930 be prohibited from endorsing specific securities sold on their site to specific purchasers, unless they apply for Broker Dealer licensing. Without engaging in endorsing, these platforms can more easily be characterized as open marketplaces and listing services (ala Craiglist) rather than active participants who influence the outcome of deals done on the site.

c) Client Information - Crowdfunding platforms should agree on and collect a reasonable set of standard information about all issuers and purchasers on their sites. Furthermore, platforms should retain this information for at least five years and make it available to FINRA if audited.

d) No guarantees - Crowdfunding businesses should never guarantee any purchaser against loss

e) Cautionary Statements - All platforms should provide clear, consistent, simple, legible cautionary statements for all purchasers while they are viewing securities information and before they make a purchase.

f) Disclosure Check - Platforms must take responsibility for completeness (but not verify accuracy) of issuer disclosures and never make securities available for purchase that are not accompanied by these appropriate disclosures.
g) Information on Recourse - Platforms must provide information on purchaser recourse in the case of lack of payment or fraud. They must also give the customer a clear way to log complaints with FINRA in the case that the purchaser is displeased with his interaction with the Crowdfunding platform itself.
h) Self Reporting - Platforms must make it clear which information on a securities sell-sheet has been self reported. If any information has been independently verified, it should be explicitly marked as such.
i) Verification of Issuer Business - Platforms must verify the identity of the business by checking its EIN against state records and, therefore, only work with incorporated US business. Platforms are responsible for taking reasonable effort in this regard, but should not be liable for false-positive results from their check.
j) Verification of Issuer Identity - Platforms must verify the identity for all issuers (for example, by matching name and social security number). Again, platforms are responsible for taking reasonable effort in this regard, but should not be liable for false-positive results from their check.
k) Issuer Background Check - Platforms must conduct background check on all issuers and prohibit those who have committed a financial or other federal crime from selling securities on the platform. And again, platforms are responsible for taking reasonable effort in this regard, but should not be liable for any inaccuracies that arise from their investigation.

Conclusion

I want to thank Chairman Garrett, Ranking Member Waters and members of the subcommittee for the opportunity to participate in this Hearing. I applaud the Committee for turning its attention toward capital formation for small businesses and thoroughly evaluating a number of innovative new approaches to this persistent issue. I am honored to have had the opportunity to share my thoughts on crowdfunding specifically. My experience starting and running ProFounder has left me with a deep respect for the small business entrepreneur and her potential to create real economic change for herself and others. Without capital from their communities, Bronson would not have been able to open his second candy shop, Raaja would never have started his sneaker company, and Mark would not be producing high performance electric motorcycles. Each of these businesses engaged in community-funding via ProFounder and went on to create jobs and infuse more capital into their local economies. I look forward to a time soon when these success stories can be replicated more widely; a time when entrepreneurs can seek investments from their community at-large in a way that is simple and efficient.

Thank you.

Written Testimony of

Vincent R. Molinari
Chief Executive Officer, GATE Technologies, LLC

Before the Subcommittee on Capital Markets and Government Sponsored Enterprises
U.S. House of Representatives Committee on Financial Services

Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation
September 21, 2011

Chairman Garrett, Ranking Member Waters, and members of the Subcommittee on Capital Markets and Government Sponsored Enterprises (the "Subcommittee"), my name is Vincent Molinari. I am the Chief Executive Officer and co-founder of Gate Technologies, LLC ("Gate"). I commend the Chairman, the Ranking Member and the Members of the Subcommittee for holding this hearing on proposals to facilitate small business capital formation and job creation. I also want to acknowledge Chairman Bachus and Ranking Member Frank and thank them for bringing this issue before the public today I offer my opinions as a businessman, an entrepreneur and the chief executive of a firm committed to the creation of new jobs through innovative capital formation.

In my invitation to testify, the Subcommittee asked me to: (i) provide specific recommendations on initiatives the U.S. Securities and Exchange Commission (the "SEC" or the "Commission") should pursue to facilitate capital formation; (ii) discuss the potential impact of President Obama's proposals to (a) establish a "crowd funding" exemption from SEC registration requirements for firms raising less than $1 million (with individual investments limited to less than $10,000 or 10% of investors' annual income); (b) increase the cap on "mini-offerings" (Regulation A) from $5 million to $50 million which will make it easier for entrepreneurs to raise capital and create jobs; (iii) provide my views on the following legislative proposals H.R. 1965, H.R. 2167 - the Private Company Capital Flexibility Act - H.R. 2930, the Entrepreneur Access to Capital Act, H.R. 2940 – the Access to Capital for Job Creators Act, and the draft Small Company Job Growth and Regulatory Relief Act of 2011.

Background

GATE is an innovative, global financial services and technology company which I co-founded in 2009. We provide technology solutions and develop platforms that facilitate the trading of illiquid securities and promote pre trade and post trade transparency. Currently, GATE operates in the United States through its wholly owned subsidiary, GATE U.S. LLC ("GATE U.S."), a broker-dealer registered with the SEC and the Financial Industry Regulatory Authority ("FINRA"). GATE U.S. operates as an agency broker and an alternative trading system ("ATS"). In addition to operation of its business through an ATS, GATE U.S. also relies on SEC no-action letters that provide flexibility for the use of Internet and other modern communication technologies in private offerings without running afoul of the general solicitation ban under federal securities laws.[1]

GATE U.S. facilitates transactions in the following asset classes: unregistered securities of private companies, restricted securities of publicly traded companies, and warrants. GATE U.S. is also working with other firms to facilitate the trading of state and federal tax credits, asset-backed securities, and limited partnership interests. Additionally, GATE has partnered with one of the largest financial services foundations to adopt platform technology for impact investing. GATE believes in creating value through trading in a structured, regulated venue where buyers and sellers meet for price discovery and to transact, settle, and transfer securities. GATE's business is fully regulated, archivable, and auditable. While the core of our business model is creating value for private companies and market participants, GATE Technologies is also an innovative, privately held, emerging company. As a result, we encounter the same capital formation and startup company issues that are encountered by other early stage companies.

We understand the SEC is monitoring the secondary trading activity on a variety of online trading platforms which are facilitating the trading of securities of private companies. The SEC has acknowledged that the trading that develops on online trading platforms such as the GATE ATS can be beneficial in that they can provide much desired liquidity to investors, which can assist in attracting investors to smaller private companies. We also appreciate the SEC's concerns that such benefits must be measured against the Commission's statutory responsibility to protect investors.

GATE believes the trading of unregistered securities is accomplished most effectively through a broker-dealer, an ATS or an exchange registered with the SEC because such transactions provide the books and records and an audit trail that can be used for surveillance purposes. In the absence of such information, an infinite allocation of resources to the SEC, will be unable to properly monitor such trading.

The Engine of Job Creation - Small Private Companies

Historically, small private companies have spurred economic growth and job creation. Many of the most prominent companies in the World, Apple, Microsoft, and Google, started as small private companies. These companies and countless other small companies are the engine of economic growth and job creation. Today, we focus on one of the major challenges of our

[1] *See, e.g.,* IPONET (July 26, 1996) (general solicitation is not present when previously unknown investors are invited to complete a web-based generic questionnaire and are provided access to private offerings via a password-protected website only if a broker-dealer makes a determination that the investor is accredited under Regulation D); Lamp Technologies, Inc. (May 29, 1998) (posting of information on a password-protected website about offerings by private investment pools, when access to the website is restricted to accredited investors, would not involve general solicitation or general advertising under Regulation D).

current economy: job creation in sufficient numbers to return unemployed and underemployed Americans to the workforce in positions that make use of their considerable talents.

The importance of small companies is evident in light of the following statistics:

- Small businesses represent 99.7 percent of all U.S. employers and employ half of the private sector workforce.
- Small business are responsible for creating 9.3 million net new jobs between 1993 and 2009, 54 percent of the total.
- Over 50 percent of U.S. private, non-farm GDP is generated by small businesses every year.

Historically, small businesses drive innovation, producing 13 times as many patents as large firms. These innovations set us apart internationally; give us the ability to lead in newly created industries; and allow us to take advantage of exchange rates that are adjusting in favor of U.S. exports.

The Causes of the Broken Engine

Private companies are critical to the U.S. economy and their ability to access capital is an important driver for growth, job creation and government tax revenues. However, the high costs of regulatory compliance associated with the Sarbanes-Oxley Act ("Sarbanes-Oxley") and the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") are limiting the ability and benefits to smaller private companies of going public. These smaller companies are seeking new methods of capital formation, and looking increasingly to private market funding alternatives, while the public market's appetite for new listings has waned. Initial public offerings ("IPOs") have decreased significantly while average deal sizes have increased, which may indicate that smaller companies appear to face increasing challenges in going public. For example:

- IPOs raising less than $50 million have dropped from approximately 80% of offerings in the 1990s to approximately 20% of offerings since 20003; and

- The 1990s saw more than 500 IPOs annually on average (during and before the internet bubble), while 2008, 2009, and 2010 combined have seen a total of 248 IPOs.

Mitigating against the above trends, new trading platforms, such as the one operated by GATE U.S., offer small private companies and investors an increasingly transparent model to access capital. As these platforms become more broadly accepted, they will also become increasingly robust and transparent through technological advances.

Recently, the spotlight has fallen on the private equity market due to investor demand for private companies such as Facebook, Zynga, and Twitter which operate in the public sphere due to their size and commercial presence. Smaller private companies, however, are looking to emulate the private financing model employed by these companies while

attempting to manage the growth of their investor base to comply with applicable state and federal securities laws.

Unfortunately, the flow of capital to these potentially dynamic job creators is anemic. The current capital formation process is painfully broken, and it is operating under policies that do not support efficient allocation and the best use of available funds. We need to increase the system's capacity and get capital moving through it. Over the past fifteen years, the standard business model for a successful company—startup to a relatively quick public offering— has been has been dramatically changed, in large part due to the bursting of the technology bubble, the rise of China as a global economic power, the unintended consequences of the adoption of Sarbanes-Oxley Act, the financial crisis of 2008, and the unintended consequences of the adoption of Dodd-Frank Act.

Initial public offerings today generally are already large, established companies. The banking industry has adjusted according to the changes in the economy: investment banks no longer provide services required to bring small- and mid-market companies to the public markets. Taken together, all of these factors have put the public capital markets out of reach for a vast swath of the private sector.

Angel investors and venture capitalists no longer see an exit sign for their capital in the foreseeable future and, as a result, become more reluctant to commit funds and to assume risk. The average hold time for a venture capitalist's investment was 4.7 years, and that hold time has now increased to ten years. Professional investors seeking to invest, profit, and then redeploy their capital elsewhere simply do not want to be in a private company for a decade or more. Due to the extended time frame, companies are forced to raise additional capital in order to offset the return on investment, thus making the climb steeper. As a result of these conditions, the flow of capital has been greatly diminished.

This situation has also created a new space in the economy that is no longer about initial public offerings and investment banks. It is about small and private companies that many never be brought to the public markets or may take a decade or more to reach the offering stage. The marketplace is telling us that there is an appetite for investment in private companies much earlier in the business growth cycle. We have an opportunity to create a system and a marketplace in which private companies can now access capital and liquidity from investors in a safe and transparent manner.

When companies have adequate capital, they can reinvest, expand, and hire. These small and private companies offer the economy tremendous growth potential and job creation, and they deserve to be supported with federal policies that make capital more available and foster their success. They have the ability to become the engine of economic recovery which is so sorely needed in the United States today.

Reform of Regulation D

Turning to the specific proposals being considered today, the proposed reform of Regulation D, as part of Representative David Schweikert's Private Company Flexibility and Growth Act,

would be a welcome change in the capital formation process that would promote economic expansion and job creation. I commend Representative Schweikert on the bill's introduction, which would increase the total asset threshold for registration to $10 million and raise the shareholder of record limitation from 500 to 1,000 persons.

In 1964, the total asset threshold for companies not required to register was set at $1 million, and the threshold was increased to $10 million in 1996. Regrettably, the 500 shareholder limitation of Section 12(g) has not been revised since it was established in 1964. Since then, the numbers of public companies and the numbers of investors have increased dramatically, and changes in technology have enabled innovative trading platforms, such as the one developed by GATE, that provide transparency and all of the investor protection offered by a broker-dealer. These technological advancements not only provide more transparency for investors, they also enable effective monitoring of private market transactions.

Section 12(g)

Section 12(g) of the Exchange Act requires a company to register its securities with the SEC, within 120 days after the last day of its fiscal year, if, at the end of the fiscal year, the securities are "held of record" by 500 or more persons and the company has "total assets" exceeding $10 million.[2] Shortly after Congress adopted Section 12(g), the Commission adopted rules defining the terms "held of record" and "total assets."[3] The definition of "held of record" counts as holders of record only persons identified as owners on records of security holders maintained by the company in accordance with accepted practice. The Commission used this definition to simplify the process of determining the applicability of Section 12(g) by allowing a company to look to the holders of its securities as shown on records maintained by it or on its behalf, such as records maintained by the company's transfer agent.[4]

When Section 12(g) was established in 1964, the Commission could not have anticipated the technological changes that have transpired since that time. These advances not only allow small companies to grow rapidly, but also bring more transparency and confidence to the financial markets. The rise of secondary private equity trading, driven by new bulletin boards and platforms that allow accredited investors and institutions to buy and sell private equity, has opened the private market to a wider potential investor base than was imagined

[2] *See* Exchange Act § 12(g)(1); Exchange Act Rule 12g-1. When Section 12(g) was enacted, the asset threshold was set at $1 million. The asset threshold was most recently increased to $10 million in 1996.
[3] Release No. 34-7492, *Adoption of Rules 12g5-1 and 12g5-2 Under the Securities Exchange Act of 1934* (January 5, 1965).
[4] *See* Release No. 34-7492, *Adoption of Rules 12g5-1 and 12g5-2 Under the Securities Exchange Act of 1934* (January 5, 1965).

when Section 12(g) was adopted. The result is a significant, unforeseen shift in the private equity landscape that has produced:

- Easier access to high-growth investments for smaller investors;
- Increased challenges for private companies to maintain a shareholder base of fewer than 500 owners, regardless of the desire or need to go public; and
- Private equity valuations that are driven by real transactions in the secondary market.

We believe that the evolution of the private equity market is unlikely to stop and more issuers will inevitably be impaired in their ability to raise capital in compliance with Section 12(g). However, Congress granted the SEC the authority to liberalize the application of Section 12(g). We encourage the SEC to exercise such authority and ask Congress to supervise the exercise of that authority.

The SEC Has the Authority to Amend the 500 Shareholder Limit

While we support the proposed legislation, we believe the SEC has broad authority under Section 12(h) to exempt issuers from the registration requirements of Section 12(g) so long as the Commission finds that the action is not inconsistent with the public interest or protection of investors. Additionally, Congress has granted the SEC broad exemptive authority in Section 36 of the Exchange Act.[5] The Commission has previously established exemptions from the Section 12(g) requirement,[6] and Section 12(g) provides the Commission with authority to define the terms "held of record" and "total assets."[7] We believe the SEC has the requisite authority to revise the 500 shareholder threshold of Section 12(g) if it concludes that doing so is not inconsistent with the public interest or protection of investors.

While believe amending Section 12(g) is consistent with the public interest and the protection of investors for several reasons. Currently, the 500 shareholder requirement of Section 12(g) is making it very difficult for small companies to raise capital. Moreover, due to the pronounced economic recession the United States has experienced and the massive capital contraction, small private companies are facing considerable difficulty raising the capital required to promote the research and product development that will encourage job creation.

[5] The Commission "may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." Exchange Act § 36.

[6] *See* Exchange Act Rule 12g3-2.

[7] "The Commission may for the purpose of this subsection define by rules and regulations the terms 'total assets' and 'held of record' as it deems necessary or appropriate in the public interest or for the protection of investors in order to prevent circumvention of the provisions of this subsection." Exchange Act § 12(g)(5).

Congress and the Commission could not have foreseen in 1964 the current state of our economy or the deleterious impact that the 500 shareholder limit of Section 12(g) would have on private companies. We believe the exigent circumstances coupled with the technological advances, including the development of ATSs, support the amendment of the 500 shareholder limit of Section 12(g).

Reform of Regulation A

Congress authorized the SEC to create the Regulation A exemption in 1933 because it recognized the economic benefit of helping small businesses secure capital through public offerings of securities. Regulation A was adopted by the SEC to enable small companies to offer their securities publicly in accordance with streamlined offering and disclosure requirements. However, the Regulation A exemption is rarely used because the $5 million threshold is too low to warrant companies incurring the time and expense to satisfy the offering and disclosure requirements. Indexing the threshold for inflation and re-visiting what the level should be on a timely basis will ensure that Congress's original intent is satisfied.

Currently, entrepreneurs and small businesses cannot access the capital they need to grow and create jobs. A record 41 percent of small business owners cannot get adequate financing, according to the National Small Business Association – up from 22 percent in 2008. A critical source of funding – the public capital markets – has been largely closed off to America's proven job creators.

Increasing the SEC's Regulation A exemption from $5 million to $50 million will improve the ability of small companies to access desperately needed capital. By reducing the regulatory burden and expense of raising capital from the investing public, Congress can boost the flow of capital to small businesses and fuel America's most vigorous job-creation machine. Regulation A can also help entrepreneurial businesses attract private capital by providing liquidity opportunities at a lower level than might be feasible for an IPO using full registration.

I commend Representative Schweikert, as well as the Financial Services Committee for considering and passing this legislation in June. I look forward to House floor action on the legislation, and I also commend the authors of Senate companion legislation that was recently introduced, Senator Jon Tester and Senator Pat Toomey. The amendment of Regulation A will Provide another powerful tool to promote capital formation and job creation.

Crowdfunding

The term "crowdfunding" generally refers to capital formation by means of a mechanism by which a group of people pool money to support a specific effort or goal. Crowdfunding typically involves small individual contributions. This strategy has been used to support the funding of books, films, music recordings and charitable causes. The use of crowdfunding as a capital formation tool has become increasingly popular.

However, the potential of crowdfunding as a capital formation tool for early stage for profit companies has been impeded by uncertainty with respect to whether such transaction are subject to the registration requirements of the federal securities laws. The SEC has been examining the permissible use of crowdfunding and possible exemptions from registration under the Securities Act to encourage the use of crowdfunding as a capital formation strategy.

We believe the use of crowdfunding as a capital formation strategy would be enhanced if the SEC were to exempt such activities from registration under the Securities Act. Such an exemption is not without precedent. The envisioned exemption would be similar to the exemption previously included in Rule 504 which allowed a public offering to investors (including non-accredited investors) for securities offerings of up to $1 million, with no prescribed disclosures and no limitations on re-sales of the securities sold.

Any concerns regarding the protection of investors would be addressed by the fact that crowdfuding would still be subject to state blue sky regulation and the anti-fraud and other civil liability provisions of the federal securities laws. Additional protections could be garnered through a requirement that crowdfunding be conducted through a regulated entity such as a broker-dealer or an ATS that must archive all transaction records in a format that is subject to applicable SEC rules with respect to preservation of auditable books and records.

GATE believes crowdfunding has tremendous potential for supporting small and private companies. Given the changes in the marketplace, increases in investor participation, and the advancement of technology, the general solicitation ban is becoming increasingly hard to defend. In the future, it is likely to become exponentially more difficult to enforce.

While information could be widely disseminated if there was an exemption to the general solicitation ban, there could still be full validation of the individual coming through the brokerage account. Those who choose to click through to the trading platform would go through the regular process to become accredited investors.

We have the ability to bridge the two worlds of social networking and investing while remaining true to investor protection and this is a powerful new paradigm. This is the sort of new thinking that will be required if we are to adequately capitalize small and private companies.

When you consider the numbers and the growth potential of social networking, I believe that eventually, the regulatory community will embrace it, even though it may seem to be a radical idea today. It is important to stress the protocol that would be in place to manage the process of accrediting investors. There is an entire layer of compliance process that would have to occur between an electronic communication and an actual investment.

Investors want to capture the beginning stages of a company's growth in order to maximize their investment. And we can use the Internet and social networking to make these distributions more broadly—and make them much fairer—than they have been in the past.

I commend Representative Kevin McCarthy and Representative Patrick McHenry for their foresight in addressing this issue. People are communicating about investments continually, and it will become increasingly difficult to identify exactly what a solicitation is and to enforce the general ban. I support progress on this issue, including two pieces of legislation that have been recently introduced, H.R. 2940, the Access to Capital for Job Creators Act, and H.R. 2930, the Entrepreneur Access to Capital Act.

Changes to Sarbanes-Oxley For Small Companies

GATE Technologies' business model is based on the belief that promoting liquidity in illiquid markets enhances economic efficiency. By promoting liquidity and transparency in a venue that is regulated as a broker-dealer and an ATS, GATE plans to attract investors that want to more efficiently manage their capital.

At the same time, accessing the public capital markets is part of the natural growth cycle for successful companies. At a certain point, companies require more capital than what is found in the private markets. The numbers and market capitalization totals of companies matriculating to the public markets are a commonly used indicator of economic health in the small company sector.

The area of accounting and corporate governance practices in publicly traded companies covered by Sarbanes-Oxley is outside my expertise. However, I support eliminating regulatory costs that are unnecessary for these companies in the interest of bolstering small company growth.

The discussion draft offered by Representative Stephen Fincher, the Small Company Job Growth and Regulatory Relief Act of 2011, offers reasonable relief from Sarbanes-Oxley Section 404 for many companies in the Russell 2000 Index. The draft is a thoughtful approach that would ease the transition for small public companies as they adjust to their new listing status and as they continue to mature. A policy change such as that being offered by Representative Fincher would be welcome news in the small company sector.

We believe that exempting issuers with less than $500 million in market capitalization from the auditor attestation requirement of Sarbanes-Oxley Section 404 will promote market efficiency, while still retaining basic internal controls and management assessment of the effectiveness of those controls.

Newly listed companies with market capitalization between $500 million and $1 billion would have five years before they would be required to step up to full Section 404 compliance, which strikes me as a reasonable and balanced approach.

Considering current economic conditions and the need to fuel growth in this sector, I would respectfully suggest that the funds that very small publicly traded companies expend to attain auditor attestation could be put to a more productive use. If Representative Fincher's legislation were to be enacted, covered companies would immediately have healthier balance sheets and greater ability to grow and to hire.

Conclusion

I am encouraged by this hearing, by the recent progress that has been made on this issue, and by the sense of cooperation displayed by the members of the Subcommittee in bringing a number of creative pieces of legislation that is meant to spur the capital formation process. I commend President Obama and Speaker Boehner for their leadership on this issue.

President Obama recently noted that his "[a]dministration will pursue efforts to reduce the regulatory burdens on small business capital formation in ways that are consistent with investor protection." Speaker Boehner noted that In his remarks to the Economic Club of Washington, D.C. last week, "[i]f we want job growth, we need to recognize who really creates jobs in America. It's the private-sector."

I commend the authors and cosponsors of the pending pieces of legislation, as well as the leadership of the relevant committees on both sides of the aisle for moving forward with continuing discussions, hearings, and markups.

We have a rare opportunity to enact policies that will further the goals of the investors and small and private company entrepreneurs, while assisting our battered economy and our unemployed workers. Taken together, these policies will have a powerful and positive economic effect that will become apparent very quickly. These changes are the best and most effective actions than could be taken right now to invigorate the economy.

On behalf of GATE Technologies, I urge continued action on these pieces of legislation and look forward to their enactment. Thank you for the opportunity to present these views in support of reforming capital formation policies.

Vincent R Molinari
Chairman and CEO
GATE Technologies

GATE
TECHNOLOGIES

Written Testimony

of

Barry E. Silbert

Founder and CEO, SecondMarket

to the

Committee on Financial Services,

Subcommittee on Capital Markets and Government Sponsored Enterprises

U.S. House of Representatives

"Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation"

SEPTEMBER 21, 2011

Good afternoon Chairman Garrett, Ranking Member Waters, and Members of the Committee. My name is Barry Silbert. I am the Founder and CEO of SecondMarket. I am grateful for the opportunity to testify this morning regarding these important subjects that pose significant challenges to our country. The issues raised in my testimony directly impact startup growth, job creation and American global competitiveness.

First, I'd like to describe SecondMarket. Second, I will discuss the problems in the public stock markets that have made the markets inhospitable to growth-stage companies. Next, I will describe the important role that SecondMarket plays in the capital formation process and in affording access to capital. Finally, I will suggest passage of the legislation that is the subject of today's hearing, particularly the bills that support growing private companies on their road to the public markets, while also maintaining a high level of investor protection.

My Background and the SecondMarket History

I was born and raised in Gaithersburg, Maryland and attended college at Emory University in Atlanta. After graduating in 1998, I started my career as an investment banker at Houlihan Lokey where I worked on some of the most prominent bankruptcies of the last decade, including Enron and WorldCom. Houlihan typically represented creditors, and the experience working on complex, problematic restructurings proved invaluable. It was this experience that led me to the idea for SecondMarket.

Upon emerging from bankruptcy, creditors in Chapter 11 cases would sometimes receive stock in the restructured company that was not saleable in the public markets. These creditors often would contact Houlihan to inquire about selling these instruments. When I asked my colleagues how we could assist the creditors with these sales, it was suggested that I should pick up the telephone, start calling my contacts, and find buyers. I was struck that there was no centralized marketplace for these assets. Thus, the idea for SecondMarket was born: a transparent, centralized and independent marketplace where buyers and sellers could transact in alternative assets.

Having long ago decided I wanted to start my own company, I left my Wall Street job and began drafting a business plan. Although the idea has evolved over time, we have always been committed to the notion of providing transparency and centralization to markets that historically had been fragmented and opaque. I founded SecondMarket in New York City in late 2004, and we opened for business in 2005. We started small and low-tech – just five guys in a tiny office with a few computers and phones.

The first asset class that we focused on was restricted securities in public companies. These are assets such as restricted stock, warrants and convertibles that are issued by public companies but not tradable in the public stock markets. Since that time, SecondMarket has experienced significant growth, and we have added several more asset classes that benefit from our core principles of transparency, centralization and independence.

What do these principles mean? Transparency means providing detailed information about the asset so that buyers and sellers can make informed investment decisions. It also means transparency into asset pricing. Centralization means bringing together buyers and sellers in a formalized, secure marketplace. Independence means we are not a subsidiary of another financial institution and, more importantly, we do not engage in proprietary trading. Thus, we do not use our own balance sheet to complete transactions. We are willing to sacrifice short-term revenue opportunities because we believe that as a global marketplace, it is critically important that our participants recognize that we are not on either side of the transaction. We are always the marketplace connecting buyers and sellers, guiding our participants through the sales process, and handling the closing and settlement of the transactions.

Since launching the first asset class in 2005, we have added markets for fixed income (*e.g.*, auction-rate securities, mortgage-backed securities, etc.), bankruptcy claims and private company stock. These asset classes have unique characteristics, objectives and participants. However, they share the common thread that they are illiquid, alternative investments that benefit from a centralized marketplace.

While we have continued to add new asset classes, the size of our participant base has also exponentially grown. At the beginning of 2009, we had 2,500 registered participants on SecondMarket. Today we have well over 75,000 participants and the number is constantly growing. Our technology has also substantially evolved as we have invested millions of dollars into our online platform, which provides centralization and efficiency to improve the user experience and streamline the sales process.

Moreover, we are no longer a few individuals in a small office. SecondMarket now employs nearly 150 people in New York and San Francisco, and we are hiring new employees every month. I should also note that SecondMarket is a FINRA registered broker-dealer and operates an SEC-registered Alternative Trading System for its private company stock market.

SecondMarket is the leading marketplace for facilitating transactions in private company stock. We have completed trades in over 60 different companies, including Facebook and Twitter. In 2008, we completed $30 million in private company transactions. In 2009, that number rose to $100 million and in 2010, we saw nearly a four-fold increase in transactional value. To date, we have completed over $850 million in private company stock transactions. Across all of our asset classes, we have completed several billion dollars in trades.

SecondMarket has emerged as an innovative solution provider. We have helped retirees get liquidity when their auction-rate securities (which were often marketed as a cash equivalent) turned out to be long-term, illiquid investments. We have been part of the sales team working in conjunction with Deutsche Bank to help the Treasury Department sell TARP warrants. And we've helped dozens of private companies provide liquidity for their shareholders, many of whom reinvested their money into other startups.

Problems in the Public Stock Markets

For several decades, startup companies in the U.S. followed a similar path: they raised angel capital, a few rounds of venture capital, and went public within five years. The vast majority of IPOs were for companies raising $50 million or less, even adjusted for inflation. Smaller companies could thrive in the public markets, with equity research coverage and market makers driving investor interest in growth-stage companies. Over the past 15 years, however, the market structure forever changed and the public markets became inhospitable to smaller companies.

Although SecondMarket is not a research company, we closely follow research findings from industry observers and analysts.[1] Several factors have been recognized by these market observers as contributing to the problems in the American public stock markets:

[1] *See* "A Wake-Up Call For America," David Weild and Edward Kim, Grant Thornton Capital Markets Series, Nov. 2009; "Market Structure is Causing the IPO Crisis – and more," David Weild and Edward Kim, Grant Thornton Capital Markets Series, June 2010; "It's Official: The IPO Market is Crippled – and it is hurting our country," Alan Patricof, *Business Insider*, Jan. 2011; "Wall Street's Dead End," Felix Salmon, *The New York Times*, Feb. 2011; "Welcome to the Lost Decade (for Entrepreneurs, IPOs and VCs)," Steve Blank, July 2010; "U.S. Falls Behind in Stock Listings," Aaron Lucchetti, *The Wall Street Journal*, May 2011.

- Online Brokers – although the introduction of online brokerages helped to make trading less expensive, these online brokers disintermediated retail brokers who helped buy, sell and market small-cap, under-the-radar public companies to investors. Stockbrokers collectively made hundreds of thousands of calls per day to their clients to discuss small-cap equity opportunities, and the proliferation of online brokerages decimated the profession. Those brokers provided a critical marketing tool for the country's small-cap companies.
- Decimalization – stock prices used to be quoted in fractions, and the difference between fractions created profit for firms providing market making, research and sales support to small-cap, public companies. When the markets began quoting prices in decimals, trading spreads were reduced and profits were significantly cut. It became unprofitable to market small-cap equity.
- Sarbanes-Oxley – the legislation is often blamed for the problems in the public markets, but many observers believe it is not the most significant factor in companies electing to remain private. Nonetheless, corporate compliance with the Sarbanes-Oxley Act has certainly increased costs, especially for smaller public companies.
- Global Research Settlement – once the investment banks began funding equity research, conflicts of interest emerged and positive equity reports began to be written for undesirable companies. This issue caused state Attorneys General to get involved, eventually resulting in the global research settlement. While based on sound public policy, the result was that research reports essentially stopped being written for small-cap public companies and, consequently, a significant marketing mechanism for small-cap companies was eliminated.

- High-Frequency Trading – although high-frequency traders bring significant liquidity to the public markets, by definition, they require the volume and velocity that can only be found in large public companies. A recent report stated that high-frequency traders conduct almost 75% of the trades taking place in the U.S. equity market, and those traders essentially ignore small-cap companies.[2]
- Average Hold Period – over the past forty years, the average time that a public market investor holds stock has dropped from approximately five *years* in 1970, to less than three *months* today. This further highlights the fact that investors are now focusing their attention on short-term earnings performance, versus long-term, business-building initiatives.[3]

Virtually all of these developments emerged from either well-intentioned policy decisions or the natural evolution of the markets in an electronic age. Nonetheless, taken in the aggregate, these (and other[4]) factors have made the public markets undesirable for many companies. These factors are not temporary and are unrelated to the current economic climate. These changes to our public stock markets are permanent and systemic, and the regulatory regime must reflect that permanence.

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[2] "Institutional Traders Around the World Concerned by High-Frequency Trading, Global Survey Shows," *MarketWatch*, Sep. 2011 (According to the Tabb Group, almost 75% of overall daily equities trading can be attributed to high frequency trading.).

[3] "Investing Dying as Computer Trading, ETFs & Dark Pools Proliferate," John Melloy, *CNBC*, Jan. 2011; "The Trading Game Is Causing the Manic Market," Daniel Indiviglio, *The Atlantic*, Aug. 2011.

[4] "Why Merger Lawsuits Don't Pay," Jessica Silver-Greenberg, *The Wall Street Journal*, Aug. 2011 (Last year, a record 353 lawsuits challenging proposed corporate mergers were filed in state and federal courts across the U.S., a 58% increase from 2009); "A Wild Ride to Profits," Jenny Strasburg, *The Wall Street Journal*, Aug. 2011 ("High-frequency traders benefit from price gyrations and high turnover in securities by moving in and out of holdings.").

Throughout the 1980's and 1990's, the regulatory environment and overall market structure actively supported high-growth private companies joining the public markets. From 1991 to 2000, there was an average of 520 IPOs per year, with a peak of 756 IPOs in 1996. Today, the lack of a properly functioning public market structure is strikingly obvious. Since 2001, the United States has averaged only 126 IPOs per year, with 38 in 2008, 61 in 2009 and 71 in 2010.[5]

Companies are electing to remain private longer than in previous decades, and the average time a company remains private has essentially doubled in recent years.[6] Moreover, the profile of companies going public has dramatically changed. Today, only the very largest companies are going public, and are receiving the sales and research support needed to successfully navigate the public markets.

Simply put, the lackluster IPO market is not providing the solution for investors and early employees who need liquidity. M&A is an alternative option for companies to obtain liquidity; however, acquisitions often result in job losses and stifled innovation. The growth market is a significant and vital part of the capital formation process, and the systemic failure of the U.S. capital markets to support healthy IPOs inhibits our economy's ability to create jobs, innovate and grow.

Consider that roughly 3,000 companies receive funding each year, yet only 100+ companies annually are going public. Putting aside those that are acquired and others that failed, there still are numerous private companies that need improved access to capital. Clearly, a new growth market must emerge.

[5] "Market Structure is Causing the IPO Crisis – and more," David Weild and Edward Kim, Grant Thornton Capital Markets Series, June 2010.

[6] *Id.*

The SecondMarket Solution

We were first approached about facilitating trades of private company stock in late 2007, when a former Facebook employee contacted us and asked if we could help him sell his shares. He had read about how we facilitated transactions in restricted stock in public companies. Since Facebook was not a public company, the stock was unregistered and Facebook did not have any plans for an IPO. We facilitated that transaction but then spent nearly a year conducting diligence to assess the viability of the market. Once we understood that companies were remaining private much longer than in prior years, and that systemic changes in the public markets made it difficult for companies to go public, we were convinced that we could fill the role of a new growth market.

The SecondMarket approach is premised on the notion that there is not a "one-size-fits-all" model for private companies. Each company has its own goals and objectives. Some companies value control and flexibility, others are more concerned with liquidity and valuation. Our business model is premised on the fact that we will not facilitate transactions in a company's equity unless that company has authorized us to do so.

In that context, we allow companies to dictate the essential elements of their marketplace, such as identifying eligible buyers and sellers, setting the amount or percentage of shares to be sold, and determining the frequency of transactions. Some companies want only former employees to sell, and some want only existing shareholders to buy. Some permit weekly trading, but many prefer to establish quarterly or annual liquidity events. Some choose to allow an open market where buyers and sellers negotiate the share price on a one-off basis, and some elect that we run an auction to establish a clearing price.

When a company uses SecondMarket to establish an exclusive liquidity program, we require the company to provide financial disclosures to eligible buyers and sellers, including two years of audited financial statements and company risk factors. Companies are increasingly comfortable with the mechanics of our market as they recognize that the confidential information they provide is only available to the companies' selected buyers and sellers in a secure, online data room administered by SecondMarket.

In developing the private company market, SecondMarket has become an important part of the capital formation process. By helping companies provide interim liquidity to shareholders, we essentially operate as a bridge to an IPO for companies that eventually want to go public, or as an alternative option for companies that wish to remain private.

Suggested Regulatory Changes

SEC Chairman Mary Schapiro has said that the SEC is reviewing the regulatory landscape to lessen the burdens on private companies. In this year's State of the Union address, President Obama ordered a review of all government regulations. He added: "When we find rules that put an unnecessary burden on businesses, we will fix them."[7] This month, in his address on job creation, the President was even more pointed in his remarks: "We're also planning to cut away the red tape that prevents too many rapidly-growing start-up companies from raising capital and going public."[8]

I applaud the focus of the Administration, and I believe that the "red tape" that the President identified can be cut away with legislation that enjoys strong bipartisan support. Rule changes in

[7] Remarks by the President of the United States in the State of Union Address, The White House, Jan. 2011.

[8] Address by the President of the United States to a Joint Session of Congress, The White House, Sep. 2011.

this area would directly impact companies' ability to access capital more readily and cheaply, help companies retain existing employees and hire new ones, and bolster American global competitiveness. At a time when our lawmakers, policymakers and regulators debate how best to create new jobs, I believe a few minor changes to the regulatory rules could have a major impact on job creation.

It may be commonly understood that venture-backed companies fuel job growth in this country,[9] but most people do not appreciate the staggering extent to which the statement is true. In its 2010 study entitled *The Importance of Startups in Job Creation and Job Destruction*, the Kauffman Foundation noted that startups create an average of three million new jobs annually and the most new net jobs in the United States.[10] The study bluntly states: "Put simply…without startups, there would be no net job growth in the U.S. economy."

Thus, it is essential that the regulatory framework recognizes this dynamic and permits these startups to flourish. Every member of Congress is concerned about job creation. It is the foremost concern of President Obama and virtually all Americans. Policymakers need to understand that any serious effort to create jobs has to address the concerns of entrepreneurs. The Kauffman study concludes by noting that "States and cities with job creation policies aimed at luring larger, older employers can't help but fail, not just because they are zero-sum, but because they are not based on realistic models of employment growth. Job growth is driven,

[9] Venture-backed companies in the United States account for more than 12 million jobs, or 11% of the total private sector employment. *Venture Impact: The Economic Importance of Venture Backed Companies to the US Economy*, National Venture Capital Journal and IHS Global Insight, 2009.

[10] *The Importance of Startups in Job Creation and Job Destruction*, Kauffman Foundation Research Series: Firm Formation and Economic Growth, July 2010. Significantly, the study notes that even during poor economic conditions, "job creation at startups remains stable while net job losses at existing firms are highly sensitive to the business cycle."

essentially entirely, by startup firms that develop organically…effective policy to promote employment growth must include a central consideration for startup firms."

SecondMarket's clients are some of the fastest-growing, most successful technology startups in the United States, and I've developed strong relationships with executives at several of these private companies. These executives are often concerned that they are not ready or able to successfully navigate the public markets. They are also concerned about regulatory hurdles that restrict their ability to remain private. The concerns are varied, but two particular regulatory hurdles are often identified:

- The so-called "500 Shareholder Rule" codified in Section 12(g) of the Exchange Act, which compels private companies to become public reporting companies once they have exceeded 499 shareholders and have more than $10 million in assets at the end of any fiscal year.
- The prohibition against "general solicitation" and "advertising" in connection with private placements of unregistered securities, which has been interpreted to mean that potential investors must have a pre-existing relationship with an issuer or intermediary before the potential investor can be notified that unregistered securities are available for sale.

These two regulatory restrictions have been in place for several decades. The shareholder threshold – which, incidentally, was initially set at 750 before being reduced – was established in 1964 and worked quite well for several decades. For many years, companies were going public within a few years of founding, and were rarely concerned about exceeding the shareholder threshold. That, however, is no longer the case.

The pay structure at startup companies generally involves giving employees below-market salaries along with options which vest over several years. The options are an economic incentive that allows employees to realize the financial upside of contributing to a successful startup. The companies prefer to give equity in lieu of cash compensation because startups generally need to conserve capital in order to grow their business. Option holders, in fact, are exempted from counting under the 500 Shareholder Rule, so awarding options to employees does not adversely impact the shareholder count until the option holders exercise the options. However, in the new reality of companies taking nearly a decade to go public, option holders are often fully vested well before an IPO, and shareholders who exercise their options *are* counted towards the 500 shareholder cap.

The significance of this development cannot be overstated. The 500 Shareholder Rule 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. Application of the rule also discourages companies from providing equity-based compensation to employees, removing one of the great economic incentives attracting the country's best and brightest employees to startups.

The 500 Shareholder Rule also directly impacts a company's financing decisions. When a private company raises capital, its management team understands that there are only 500 total "slots" for shareholders -- both employee owners and investors. That means limiting the pool of potential individual and institutional investors that will have access to the investment opportunity.

This is particularly relevant when considering "crowdfunding" legislation, which the President has supported in concept. Raising small amounts of capital from many investors is extraordinarily difficult with only 500 investor slots. While I certainly support creating a crowdfunding exemption to the securities laws, crowdfunding is only a viable fundraising option if the 500 Shareholder Rule is revised and additional slots are created.

The prohibition against general solicitation is similarly problematic. Under many of the existing SEC private placement exemptions, only "accredited investors" are eligible to purchase private company stock. An individual must meet certain financial standards to qualify as an accredited investor. 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.

As previously noted, the prohibition against general solicitation and advertising requires that issuers and intermediaries have a pre-existing relationship with the accredited investor in order to make offerings available. In fact, if a non-accredited individual *is even aware* of an offering of unregistered securities, the entire offering may be at risk due to the prohibition against general solicitation.

Frankly, if only accredited investors are eligible to purchase unregistered securities, shouldn't we strive to maximize the pool of accredited investors that have access to the offering? It should not matter that non-accredited individuals know that unregistered securities are available for sale. No one prohibits car manufacturers from advertising, even though children under the legal driving age are viewing the advertisements, and pharmaceutical companies are free to advertise to people who do not have (and are not eligible for) prescription medication. The general solicitation prohibition unnecessarily limits the pool of potential investors, thereby restricting companies' ability to raise capital to fuel growth.

Currently, all buyers on SecondMarket must be accredited investors (even in asset classes where it is not a regulatory requirement). Should the ban on general solicitation be eliminated, we would support an SEC effort to mandate a more stringent onboarding process for all market participants to ensure that accredited investors meet the eligibility requirements. In fact, to that end, we have actively been exploring strengthening our internal onboarding and verification processes.

I believe that all five bills being considered today are important for our country's entrepreneurs and will help improve access to capital for startups. However, I wish to focus on two of the bills that I believe warrant immediate passage by this Congress:

1. "The Private Company Growth and Flexibility Act" (H.R. 2167), which increases the 12(g) shareholder threshold from 500 to 1,000. This bill also includes two important exemptions from the shareholder count: (1) current and former employees who received equity under an exempt equity compensation plan and (2) accredited investors.[11] This bill was introduced by Representatives Schweikert and Himes, and enjoys broad bipartisan support.

[11] Both classes of shareholders would be excluded from the shareholder count, allowing private companies the flexibility needed to successfully grow their businesses. The SEC has determined that employees taking shares under an exempt equity compensation plan and accredited investors do not require registration-level protections. Thus, implementation of this exemption would not breach the SEC's investor protection mandate.

2. "The Access to Capital for Job Creators Act" (H.R. 2940), which eliminates the ban against general solicitation and advertising in the context of issuer private placements under Rule 506 of Regulation D, provided that the ultimate purchaser qualifies as an accredited investor.

These proposals are extremely important but are not new concepts: industry experts and participants have advocated for implementing these changes for many years.[12] In 2009, the SEC kindly invited me to participate in its Small Business Capital Formation Forum. I accepted the invitation and participated on a panel regarding the state of small business capital formation. I also listened to multiple panelists advocate for some or all of these changes. In fact, for several years, the Forum's participants have recommended that the SEC increase the shareholder threshold, and for over a decade the participants have recommended that the SEC eliminate the ban against general solicitation in the context of private placements.

I recognize that passage of the Dodd-Frank Act significantly added to the SEC's rulemaking responsibilities, and implementation and enforcement of these new rules will be challenging. Nonetheless, I believe the problems facing growth-stage companies in this country must immediately be addressed, and these narrowly tailored, straightforward bills are steps in the right direction.

While I do not have the expertise to opine at length about the other bills under consideration today, I also support policy changes to create an exemption to the securities laws to permit

[12] *See, e.g.,* Final Report of the SEC Government-Business Forum on Small Business Capital Formation to the United States Securities and Exchange Commission, Nov. 2010, Sep. 2009, Nov. 2008, Sep. 2005, Sep. 2004, Dec. 2003, Feb. 2002, May 2001 (advocating eliminating the prohibition against general solicitation); Nov. 2010, Sep. 2009, Nov. 2008 (advocating exemption of accredited investors from the shareholder limit); Nov. 2010, Sep. 2009 (advocating increasing the 500-shareholder limit).

crowdfunding, allow community banks to have 2,000 shareholders, and ease the compliance requirements for Sarbanes-Oxley. I also support the legislation put forth by Rep. Schweikert and endorsed by the President to increase the cap on "mini offerings" under Regulation A from $5 million to $50 million.

Conclusion

In summary, I want to thank Chairman Garrett, Ranking Member Waters, and the members of the Committee for the opportunity to participate in this important Hearing. I also want to thank the SEC for consideration of these rule changes.

Thank you.

BIOTECHNOLOGY INDUSTRY ORGANIZATION

HEARING TESTIMONY

William D. Waddill

Senior Vice President and Chief Financial Officer,
OncoMed Pharmaceuticals, Inc.

On behalf of the Biotechnology Industry Organization

Before the United States House of Representatives Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises

"Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation"

September 21, 2011

Good morning Chairman Garrett, Ranking Member Waters, Members of the Committee, ladies, and gentlemen. My name is William Waddill, and I am Senior Vice President and Chief Financial Officer of OncoMed Pharmaceuticals in Redwood City, California. I am also the Co-chairman of the Finance and Tax Committee at the Biotechnology Industry Organization (BIO). I want to thank you for the opportunity to speak with you today about the unique hurdles that innovative biotechnology companies face and the ways in which the federal government can encourage and speed the development of cures and treatments to the crippling illnesses that affect families across the nation by removing burdens to innovation.

Biotechnology has incredible potential to unlock the secrets to curing devastating disease and helping people to live longer, healthier, and more productive lives, but the barriers that small biotech companies encounter on a daily basis raise some important questions: Would we rather see the next generation of breakthrough cures discovered by researchers in New Jersey or New Delhi? Do we want the jobs associated with this groundbreaking science to go to workers in San Francisco or Shanghai? If we want more scientific breakthroughs that allow us to enjoy a high quality of life – indeed, breakthroughs that save the lives of our loved ones – then shouldn't we put in place policies that encourage innovation?

While the biotechnology industry faces significant challenges, we nonetheless have the ability to deliver the next generation of cures and treatments to the bedsides of patients who desperately need them while at the same time creating a healthier American economy. The 1.42 million Americans directly employed by biotech are driven to treat and heal the world, but in order for them to be able to do so, Congress must remove the barriers to innovation that we face.

Innovation in biotechnology leads to the medical breakthroughs that cure and treat devastating diseases like cancer and Alzheimer's and allow real people to see their grandkids graduate from college or walk their daughters down the aisle.

The leash that holds our industry back from helping more people is, in large part, the exorbitant costs of developing a treatment that must be undertaken by a growing company. Today, Congress has the opportunity to help speed lifesaving cures and treatments to patients by removing burdens to innovation in our industry.

My company, OncoMed Pharmaceuticals, is working at the cutting edge of oncology research, focusing on a specific set of cells within tumors that drives the growth of the tumor and can morph into various cell types within the tumor. We have developed the ability to isolate and monitor these tumor initiating cells using specific surface markers and technologies. Our studies have shown that tumor initiating cells are more resistant to standard chemotherapy agents and radiotherapy. So, some current treatments may succeed at initially decreasing the size of a cancer, but leave behind an increased proportion of the most malignant cells. We have developed a portfolio of antibodies and have tested them within xenograft models derived from freshly resected human cancers. These antibodies target biologic pathways critical for survival of tumor initiating cells. We believe these models are more representative of the effects of these treatments in cancer patients than traditional models using cancer cell lines, which may no longer accurately reflect the properties of the original tumor. Currently we have three antibodies that target tumor initiating cells in Phase I and are developing other promising therapeutic candidates.

BIO represents more than 1,100 innovative companies like mine, along with academic institutions, state biotechnology centers, and related organizations in all 50 states. Entrepreneurs across the biotech industry are conducting groundbreaking science like ours, and are deeply invested in treating the severe illnesses that families around the nation and world face. At the same time, biotech leaders must deal with the day-to-day challenges of running a small business. Of great import in the biotechnology industry is the constant struggle to find working capital. It takes 8 to 12 years for a breakthrough company to bring a new medicine from discovery through Phase I, Phase II, and Phase III clinical trials and on to FDA approval of a product. The entire endeavor costs between $800 million and $1.2 billion. Due to this capital-intensive process, we must turn to the public markets in the later stages of research to fund large-scale and expensive clinical trials.

Sarbanes-Oxley Section 404(b) Exemption

As you know, the Sarbanes-Oxley Act (SOX) was passed in 2002 with the intent of protecting public investors from corporate fraud. At the time, President Bush praised it as a collection of "the most far-reaching reforms of American business practices since the time of Franklin D. Roosevelt." While we can all agree that investors benefit from greater transparency, some of the regulations found in SOX, namely Section 404(b), are unnecessarily burdensome on smaller companies, and often involve onerous compliance with little to no benefit to investors or the general public. In fact, many biotech companies facing their first few years on the public market are forced to divert funds from scientific research and development to the stringent Section 404(b) auditing requirements. The opportunity cost of this compliance can prove damaging, resulting in already limited resources being driven away from a company's search for cures and treatments.

The biotechnology sector is especially disadvantaged by the compliance burden of Section 404(b) due to the unique nature of our industry. The long, capital-intensive development period intrinsic to biotechnology often causes companies to have a relatively high market capitalization (caused by multiple rounds of venture financing prior to going public) but little to no revenue. All public companies with market caps greater than $75 million are forced to comply with Section 404(b), even though most biotech companies in a cash-strapped financial position can ill afford to pay for expensive external attestation of internal financial controls.

The main problem that these regulations cause for emerging public biotechnology companies is the need to divert resources away from innovation development to compliance for Section 404(b). The compliance costs are fixed and ongoing, and have a severe impact on the long-term investing of microcap and small cap companies at the forefront of developing new treatments for severe diseases. These small companies are the most affected by SOX at a time when they often have little or no product revenue to devote to compliance costs and must, as a result, shift funds from core research functions. This can lead to research programs being shelved or slowed as compliance takes precedence.

Further, the true value of biotech companies is found in scientific milestones and clinical trial advancement toward FDA approvals rather than financial disclosures of losses incurred during protracted development terms. Investors often make decisions based on these development milestones rather than the financial statements mandated by Section 404(b). Thus, the financial statements required do not provide much insight for potential investors, meaning that the high costs of compliance far outweigh its benefits.

As U.S. biotech companies face a mountain of regulatory hurdles, other countries are increasing their investments and enacting intellectual property protections to encourage their own biotech growth. The United States still holds its place as the leader in global biotechnology thanks to our large head start, but China and India rank first and second in biotech patent growth. These emerging powers are heavily investing in science, and particularly in biotechnology. Meanwhile, trouble in the U.S. IPO market has decreased the number of public biotech companies in the U.S. by 23% since 2008 as China's biotech IPO market continues to grow.

Strengthening the public market and removing regulatory burdens for public companies could incentivize U.S. companies that might otherwise remain private or list abroad to choose the U.S. public markets as their place of business. History has shown that job growth is accelerated when a company moves from private status to public. To encourage continued biotech innovation in the United States, as well as to grow and retain jobs, Congress should relieve small companies from the overly burdensome regulations found in Section 404(b).

Section 989G of the Dodd-Frank Wall Street Reform and Consumer Protection Act is an important acknowledgment by Congress that Section 404(b) of Sarbanes-Oxley is not an appropriate requirement for many small reporting companies. Dodd-Frank sets a permanent exemption from Section 404(b) for companies with a public float below $75 million. This provision is particularly important because it provides consistency to companies who now have a clear understanding as to whether or not they are exempt. However, it is too narrow in practicality and must be raised. Because of the business model of innovative industries like biotechnology, companies generally have very low revenues compared to their market capitalizations. For example, it is not uncommon for a newly public biotech company to have a market capitalization in excess of $600 million but have product revenues of $1 million or less. Such a company would be required to fully comply with Section 404(b) despite its lack of revenue with which to pay for compliance.

In 2006, the SEC Small Business Advisory Board recommended that the permanent exemption be extended to companies with public floats less than $700 million to better fit the business model of industries like biotechnology. The Advisory Board's proposed ceiling would allow small innovative companies to focus on speeding cures and treatments to patients rather than SOX compliance.

The Advisory Board also realized that public float alone does not fully portray the complexity and risk associated with a reporting company, and suggested a revenue test to paint a fuller picture. Revenue should be a critical consideration when determining the appropriateness of Section 404(b) compliance, along with public float. The addition of a revenue test would better serve the congressional intent behind Sarbanes-Oxley by reflecting the truly small nature of companies with little or no product revenue. Public companies with a public float below $700 million and with product revenue below $100 million should be permanently exempt from Section 404(b), allowing them to focus their resources on critical research and development.

Financial Services Capital Formation Proposals

As you know, the regulations in Sarbanes-Oxley only apply to public companies. However, many small companies in the biotechnology industry have remained private, in large part due to the travails of the public market in general, and SOX in particular. Those companies that are not yet suited to enter the public markets face their own unique burdens as they seek growth.

SEC Regulation A (Direct Public Offerings)

Regulation A, adopted by the SEC pursuant to Section 3(b) of the Securities Act of 1933, was created to provide smaller companies with a mechanism for capital formation with streamlined offering and disclosure requirements. Updating it to match today's market conditions could provide an important funding source for small biotechnology companies.

Regulation A allows companies to conduct a direct public offering valued at less than $5 million while not burdening them with the disclosure requirements traditionally associated with public offerings. The intent of Regulation A was to give companies which would benefit from a $5 million influx (*i.e.*, small companies in need of capital formation) an opportunity to access the public markets without weighing them down through onerous reporting requirements.

However, the $5 million offering amount has not been adjusted to fit the realities of the costs of development and Regulation A is not used by small companies today. The current threshold was set in 1992 and is not indexed to inflation, pushing Regulation A into virtual obsolescence. As it stands, a direct public offering of just $5 million does not allow for a large enough capital influx for companies to justify the time and expense necessary to satisfy even the relaxed offering and disclosure requirements.

I believe that Regulation A could have a positive impact for small biotechnology companies if its eligibility threshold was increased from $5 million to $50 million while maintaining the same disclosure requirements. This increase would allow companies to raise more capital from their direct public offering while still restricting the relaxed disclosure requirements to small, emerging companies. Regulation A reform could provide a valuable funding alternative for small biotech startups, giving them access to the public markets at an earlier stage in their growth cycle and allowing them to raise valuable innovation capital.

SEC Reporting Standard (Shareholder Limit)

Although the SEC in general monitors public companies, the agency also keeps tabs on private companies when they reach a certain size. Modifying the SEC's public reporting standard would prevent small private biotechnology companies from being unnecessarily burdened by shareholder regulations.

Once a private company has 500 shareholders, it must begin to disclose its financial statements publicly. Biotechnology companies are particularly affected by this 500 shareholder rule due to our industry's growth cycle trends and compensation practices. Currently, the IPO market is essentially closed to biotechnology, leading many companies to choose to remain private for at least 10 years before going onto the public market. This long timeframe can easily result in a company having more than 500 current and former employees, most of whom have received stock options as part of their compensation package. Under the SEC's shareholder limit, a company with over 500 former employees holding stock, even if it had relatively few current employees, would trigger the public reporting requirements. Exempting employees from any shareholder limit is a minimum necessary measure to ensure growing biotech companies are able to hire the best available employees and compensate them with equity interests, allowing them to realize the financial upside of a company's success.

Also, including accredited investors in the private company shareholder count does not serve the intended purpose of protecting retail investors. The SEC recognizes that accredited investors are a unique class that does not require the same level of protection as other investors. By including them in the 500 shareholder limit, growing private companies are forced to rely primarily on institutional investors because they need to maximize funding without triggering the limit. This excludes retail investors, whom the SEC was originally trying to protect, from taking part in this process.

Additionally, increasing the shareholder limit from 500 to 1000 would relieve small biotech companies from unnecessary costs and burdens as they continue to grow. As it stands, the limit encumbers capital formation by forcing companies to focus their investor base on large institutional investors at the expense of smaller ones that have been the backbone of our industry. Further, it hinders a company's ability to compensate its employees with equity interests and negatively affects the liquidity of its shares. Increasing the shareholder limit and exempting employees and accredited investors from the count are measures that, together, would remove significant financing burdens from small, growing companies.

Closing Remarks

The U.S. biotechnology industry remains committed to developing a healthier American economy, creating high-quality jobs in every state, and improving the lives of all Americans. Additionally, the medical breakthroughs happening in labs across the country could unlock the secrets to curing the devastating diseases that affect all of our families. There are many pitfalls and obstacles endemic to this effort, including scientific uncertainty and the high costs of conducting research. However, the challenges added via Sarbanes-Oxley continue to stand in our way without providing any real benefit to the investors the law purports to protect. Congress has the opportunity to support and inspire biotechnology breakthroughs by unburdening startup companies and allowing innovators and entrepreneurs to continue working toward delivering the next generation of medical breakthroughs – and, one day, cures – to patients who need them.

September 21, 2011

Testimony of

Matthew H. Williams

On Behalf of the

American Bankers Association

before the

Subcommittee on Capital Markets and Government Sponsored Enterprises

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Chairman Garrett, Ranking Member Waters, and members of the Subcommittee, my name is Matthew Williams, and I am the Chairman and President of Gothenburg State Bank in Gothenburg, Nebraska. I also serve as the Vice Chairman of the American Bankers Association (ABA). ABA represents banks of all sizes and charters and is the voice of the nation's $13 trillion banking industry and its two million employees.

The topic of this hearing today is an important one for a great many community banks whose shareholders include generations of families and local community members. Many of these community banks have faced a rule that has remained in place for over 40 years without being updated. That rule, which implements parts of the Securities Exchange Act of 1934, causes small, local banks to be subject to the same costly reporting requirements as large public firms. Although my bank is not subject to this rule, I have spoken with many community banks around the country who have struggled with the impact of the increased costs and reporting associated with the Exchange Act rule.

The Exchange Act has two tests to determine whether a company must register its securities with the Securities and Exchange Commission (SEC) and thus become subject to the SEC's significant reporting requirements: $10 million in assets and 500 shareholders of record. Since ***99.5 percent of banks reach the asset threshold for registration as a public company***, the only meaningful test of whether a bank should be registered as a public company is the number of shareholders. ***But while the asset threshold has been increased tenfold since 1964, the shareholder threshold has stayed the same.***

Banks that are nearing the 500 shareholder threshold may have nowhere to turn to raise capital they need to meet the credit needs of their communities. And once registered as a public company, banks are subject to disproportionately high financial and opportunity costs when compared to other smaller public companies. These regulatory requirements and costs eat into capital and limit banks' ability to make loans in their communities.

ABA has long advocated that the shareholder threshold be increased, an update that is much overdue. We are grateful to Vice Chairman Schweikert and to Representatives Himes and Womack for introducing legislative solutions to this problem. These bills would update the shareholder threshold for registration – up to as many as 2,000 shareholders, a level that ABA strongly supports – and allow the SEC to provide much-needed regulatory relief for community banks. ***This change would enable banks to deploy their capital in lending rather than spend it on regulatory requirements that provide little incremental benefit to the banks, shareholders, or the public.***

In addition, this legislation is an opportunity to address the threshold for deregistration, which can occur when the number of shareholders decreases and once-public businesses can become private. Currently, the number of shareholders of record must fall below 300 shareholders before the business can deregister. Raising the threshold for deregistration along with the threshold for registration makes a lot of sense from both a business and corporate governance perspective.

The urgency to address this issue increases every day. Over the last several years, banks have faced increased regulatory costs. This is exacerbated by bank regulators piling on new requests for even greater levels of capital. Combined with hundreds of new regulations resulting from the Dodd-Frank Act, these pressures are slowly but surely strangling traditional community banks, handicapping their ability to meet the credit needs of their communities. Increasing the shareholder limit would open up an avenue to bring capital into small community banks.

ABA is very interested in working with the Subcommittee to move legislation forward that can accomplish these important changes, so that community banks can continue to reach out to our communities for the capital that is vitally important in our efforts to increase lending in our communities.

Before I continue, there is one thing I would like to make very clear: the banking industry is not seeking these changes in order to stop providing investors with disclosures. As this Subcommittee well knows, community banks are part of a highly regulated industry governed by numerous statutes and regulations affecting almost every aspect of banking activity. Each banking institution is regulated by two agencies: a primary federal regulator and, in the case of state chartered banks, by the state regulator, as well. Significant financial and other information regarding every bank and savings association can be publicly viewed on the website maintained by the FDIC. ***All banks are required to make annual reports available to both their customers and investors***. Most provide financial and other information to investors through their company websites. The advantage to the small community banks from increases in the registration and deregistration thresholds would not be a lack of transparency, since keeping shareholders and the public fully informed about the bank's performance is essential to its presence as a community bank. Rather it is a reduction of regulatory burdens and reporting requirements that pose a disproportionate burden on small community banks.

There are two points I would like to make today:

- Community banks are disproportionally burdened by the 500 shareholder threshold; and
- A higher shareholder threshold more accurately reflects public company status.

I. Community Banks Are Disproportionally Burdened by the 500 Shareholder Threshold

Community banks with 2000 shareholders or less are ***local businesses with local shareholders***. These institutions had median revenue of $9.15 million and a median 182 full-time employees as of the second quarter 2011. It is common for these banks to receive little or no analyst coverage, have a limited trading market, and attract little – if any – institutional investment. The small benefit that banks receive from being public is significantly undermined by the disproportionately high costs of regulatory compliance for small companies. It is well documented that the costs of being a public company are disproportionately borne by smaller public companies.[1] Furthermore, banks are already subject to comprehensive regulation and disclosure requirements by the banking regulators while other small companies are not.

These costs come directly out of capital, reducing banks' ability to lend. Capital is the foundation for all lending and is also critical to absorb losses when loans are not repaid. In fact,

[1] See Generally, Foley & Lardner, The Cost of Being Public in the Era of Sarbanes-Oxley (August 2, 2007) available at http:/www.foley.com/publications/pub_detail.aspx?pubid=4487; Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies, SEC Release No. 33-8666 (March 3, 2006) [71 FR 11090].

$1 worth of capital supports up to $10 in loans. The downward spiral of the economy has created losses and stressed capital levels; consequently, the bank regulators have pushed banks to raise their capital-to-assets ratio. Not surprisingly, when the economy is weak, new sources of capital are scarce. Capital may become impossible for banks that are nearing the 500 shareholder threshold. The result is that these banks are forced to shrink – by making fewer loans in order to raise their capital-to-assets ratio. Clearly, it would be better to turn to additional investors to put new capital in place that would support additional community lending.

Furthermore, the negative impact of the low shareholder threshold is felt more acutely by community banks. Unlike other small businesses, community banks are broadly held by shareholders ***in their communities***. Even without ever offering shares publicly, many community banks have seen their shareholder base grow as successive generations distributed their stock holdings among their descendents. These factors exert significant pressure on banking organizations and other affected companies to reduce the number of shareholders in order either to avoid registration requirements or to deregister.

Due to the increasing costs of being a registered public company, a number of small businesses, including some of our member community banks, have determined that deregistration is in the best interests of their shareholders. However, companies that wish to deregister must either have less than $10 million in assets or less than 300 record shareholders. Since 99.5 percent of banks have greater than $10 million in assets, banks who wish to deregister must somehow reduce their shareholder base below 300 record shareholders.

Reducing the number of record shareholders can be costly. Stock buybacks, reverse stock splits and the attendant legal costs are particularly expensive for small businesses. In addition, these transactions can have negative consequences for local communities. As much as community banks would like to get out from under the heavy weight of SEC registration, they often have no desire to reduce the number of shareholders, especially if that means disenfranchising the localized ownership that makes these banks members of the community.

A fellow ABA member – Daniel Blanton, President and CEO of Georgia Bank Financial Corporation – recently testified on this before the SEC Advisory Committee on Smaller Public Companies:

> We are reluctant to [deregister] because the Bank was founded on the belief that the Augusta [Georgia] area needed a locally owned and operated, relationship-based bank. Most of our shareholders live within our market and all but a few do some business with the bank. This localized ownership is quite common at community banks across the U.S. Often times, investing in the local bank is the only remaining investment members of a community can still make.

In other words, not only do community banks benefit from having close relationships with local investors, but those same investors looking for ways to invest locally benefit from having local institutions to invest in that are not franchises or businesses otherwise related to companies that are headquartered outside the community. In addition, community banks that cannot reasonably go private due to a large shareholder base could be forced to merge with a larger partner in order to spread out the cost of compliance. Such regulatory-induced mergers or disenfranchisement should be avoided as a matter public policy.

II. A Higher Shareholder Threshold More Accurately Reflects Public Company Status

In 1964, when Section 12(g) was enacted to expand the registration and reporting requirements beyond companies traded on a national exchange, Congress understood the need for the regulation to be scaled and thus limited the reach of the provisions to ensure that "the flow of proxy reports and proxy statements [would] be manageable from a regulatory standpoint and not disproportionately burdensome on issuers in relation to the national public interest served."[2] Companies are not considered to have a large enough public market presence to be subject to significant reporting under the Exchange Act unless both the asset and shareholder thresholds are met.

In the more than 40 years since Section 12(g) was adopted, the size of the investing market has grown substantially, as has the number of corporations and the number of investing shareholders. A small corporation today with a small investor footprint is significantly different from what it was 40 years ago. While the shareholder threshold of 500 at one time may have been an accurate reflection of a public market, it no longer is today.

[2] Securities Acts Amendments of 1964, Pub. L. No. 88–467, 78 Stat. 565 (adding Section 12(g), among other provisions, to the Exchange Act); .S. Rep. No. 88-379, at 19 (1963).

For the banking industry, the shareholder number is the only meaningful Section 12(g) measure because 99.5 percent of all banks have assets in excess of $10 million. Banks have large dollar assets because the loans they make are considered assets while the deposits they hold are considered liabilities. To give the Subcommittee some perspective, the bank regulators define a small bank for purposes of the Community Reinvestment act as an institution with less than $1 billion in assets,[3] so virtually all community banks that are considered small, in at least one context, will exceed the asset size parameter of the Section 12(g) test.

Over time, the asset measurement standard set by Congress in 1964 has been adjusted "to assure that the burdens placed on issuers and the Commission were justified by the numbers of investors protected, the size of the companies affected, and other factors bearing on the public interest, as originally intended by Congress."[4] Nonetheless, while the asset size parameter has been increased ten-fold from the $1 million level initially required in 1964 to $10 million in 1996 to reflect the exponential growth in the securities market, the 500-shareholder threshold has never been adjusted to reflect the dramatic increase in the number of securities investors, although the SEC noted in 1996 its intention to consider updating the threshold.

Conclusion

My bank's focus, and those of my fellow bankers throughout the country, is on developing and maintaining long-term relationships with customers – and shareholders – many of which live in and around our communities. The antiquated 500 shareholder rule limits banks' ability to reach out to their communities for the capital that is greatly needed to support lending. Updating this rule will provide another valuable capital tool as banks work to improve the economy in our local areas and in the whole of the U.S.

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[3] See e.g., 12 C.F. R. §228.12 (u).
[4] Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies, SEC Release No. 33-8666 (March 3, 2006) [71 FR 11090, 11097].

BURROUGHS & CHAPIN COMPANY, INC.
Family Values Since 1895

September 19, 2011

The Honorable Spencer Baucus
Chairman
Committee on Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Barney Frank
Ranking Member
Committee on Financial Services
U.S. House of Representatives
2252 Rayburn House Office Building
Washington, DC 20515

The Honorable Scott Garrett
Chairman
Subcommittee on Capital Markets
U.S. House of Representatives
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
Subcommittee on Capital Markets
U.S. House of Representatives
Washington, DC 20515

Via Electronic Mail

Dear Mr. Chairman and Members of the Committee:

Thank you for the opportunity to submit this letter in support of HR 2167, the "Private Company Flexibility and Growth Act."

I am writing as President and Chief Executive Officer of Burroughs & Chapin Company. Headquartered in Myrtle Beach, Burroughs & Chapin Company is one of South Carolina's largest private land owners and a leading source of exceptional residential and resort development, commercial development and leasing, property management, and sports, entertainment and recreation offerings.

Burroughs & Chapin Company has been a closely-held family-owned company for more than 100 years. It is a sixth generation business with approximately 250 shareholders and an expanding shareholder base.

As a family business, Burroughs & Chapin Company has been dedicated throughout its history to building and improving the communities in which we do business. The company makes a conscious effort to return our profits to the communities through contributions, leadership and volunteerism to create stronger and healthier places to work and live. The company has made major monetary and land donations in communities where we operate. Much of this is made possible by shareholder dividend income channeled to numerous civic, religious and charitable causes.

Over the years, we have made a positive difference wherever we have operated. But we can continue to do so only to the extent that we maintain a favorable business environment where government regulations do not impede our company's growth and economic activity.

Our shareholder base will soon reach a level that will trigger the additional and burdensome regulatory reporting requirements to the Securities and Exchange Commission imposed by Section 12(g) of the Securities Exchange Act of 1934.

Section 12(g) of the Securities Exchange Act of 1934 sets reporting requirements for companies with more than $10 million in assets and more than 500 shareholders. The 500-shareholder test has not been adjusted to keep pace with general population growth and trends, while the shareholder base of many family-owned companies has been expanding exponentially. Burroughs & Chapin Company is a prime example of a family company which has experienced this growth and soon is to be impacted by the 500-shareholder test.

Our accountants have advised us that in order to continue our flexibility as a family business, we must soon address the Section 12(g) requirements. They have estimated that once reaching the Section 12(g) threshold, it will cost our company an additional $1 million annually in accounting and legal fees.

HR 2167 will amend the Securities Exchange Act of 1934 to change the threshold number of shareholders for required registration under the Act from 500 persons to 1,000 persons. We support HR 2167.

Failure to raise the threshold will have other negative effects on our company. As a family business, failure to raise the threshold will result in further restricting the flexibility with which management can communicate with our shareholders and will add other significant accounting costs to the normal course of business activity. It will formalize otherwise informal activities within the company and add layers of paperwork and record-keeping. These implications, we believe, are an unintended consequence for family businesses like ours and a hindrance to economic recovery.

We appreciate the Committee's bipartisan efforts to address this problem which is confronting small businesses like ours. The Chairman of our company, Chairman-designate, and I were fortunate to meet with your staff in June to express our concerns about this issue. We are appreciative of your effort to address the issue, and we are available to answer any additional questions from the Committee or from staff as you markup HR 2167 and move it through the legislative process.

Please let me know if you need further information, and how I may be helpful in assisting the Committee in advancing HR 2167.

Sincerely,

BURROUGHS & CHAPIN COMPANY, INC.

James W. Apple, Jr.
President and Chief Executive Officer

CUNA
Credit Union National Association
cuna.org
BILL CHENEY
President & CEO

601 Pennsylvania Ave., NW | South Building, Suite 600 | Washington, DC 20004-2601 | PHONE: 202-508-6745 | FAX: 202-638-3389

September 20, 2011

The Honorable Scott Garrett
Chairman
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Dear Chairman Garrett and Ranking Member Waters:

On behalf of the Credit Union National Association (CUNA)[1], thank you for holding the hearing entitled, "Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation". Access to capital for small businesses is absolutely critical given our current economic situation.

One of the crippling blows to economic recovery over the last few years has been the significant decline in business lending by large and community banks. The banks blame their reduced business lending performance on a number of factors: regulator and examiner pressures, reduced demand, and lack of capital. However, what is interesting about the banker excuses for not serving small businesses during the financial crisis is that while banks have turned their backs on many small business customers, credit unions have experienced growth in their business lending portfolios. A lack of demand has not been an issue for credit unions, many of which have former bank customers seeking business loans after having lines of credit withdrawn by the banks. Indeed, in the four years ending June 2007 bank lending to small businesses has declined by 11% whereas credit union business lending has increased rather dramatically. Unfortunately, as the credit unions with the most experience serving their small business-owning members approach the statutory member business lending cap, they will need to pull back their lending to small businesses. In fact, we are already seeing this in some cases.

Representatives Ed Royce and Carolyn McCarthy have introduced H.R. 1418, the Small Business Lending Enhancement Act. This bi-partisan legislation would increase the statutory credit union member business lending (MBL) cap from 12.25% of a credit union's total assets to 27.5%, and impose statutory and regulatory safeguards on the increased lending designed to protect the National Credit Union Share Insurance Fund (NCUSIF) from increased risk. These additional safeguards were designed by the Treasury Department and the National Credit Union Administration (NCUA). If this legislation is enacted, we estimate that credit unions could lend an additional $13 billion to their small business-owning members in the

[1] CUNA is the largest credit union advocacy organization in the United States representing nearly 90% of America's 7,600 state and federally chartered credit unions and their 93 million members.

The Honorable Scott Garrett
The Honorable Maxine Waters
September 20, 2011
Page Two

first year, helping them to create 140,000 new jobs, without an outlay of a single taxpayer dollar.[2]

The only group that opposes this legislation is the bank lobby. They talk about un-level playing fields and that the legislation may only benefit a handful of credit unions. The problem is that their arguments do not hold water.

If all credit union member business loans outstanding were considered "small business loans," credit unions would still have only 6% of all small business loans at depository institutions and a substantially smaller presence when non-depository providers are factored into the equation.[3] Credit unions represent a small presence in the business loan marketplace and clearly are not a competitive threat to commercial banking interests. Even if the cap were increased as H.R. 1418 proposes and credit unions used all of the capacity under the new cap, the banking industry would still have close to 90% of the small business lending market in the country. Is it not enough for the banks which, in recent years, have demonstrated reduced interest and capacity to meet the needs of small business owners to control 90% of the market? If there is truly an un-level playing field favoring credit unions, how is it that the bankers enjoy such market domination?

The bankers regularly suggest that the segment of the credit union movement approaching the cap is insignificant relative to the size of the movement. Today, there are approximately 175 credit unions that are essentially at the cap (> 10% of total assets); another 180 credit unions are quickly approaching the cap and will likely be capped within 2-3 years (7.5% - 10% of total assets). Together, these credit unions account for approximately 55% of all business loans subject to the cap. These credit unions have been the major contributors to credit union business lending growth in the past few years; however, over the next few years, their loan growth will dry up without an increase in the cap. The banker argument also ignores the fact that the cap has a chilling effect on credit union entry into the business lending arena: For

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[2] Our estimates are based on the following conservative assumptions: 1) no increase in lending by grandfathered credit unions; 2) in the aggregate, non-MBL lenders increase their loans to 1% of assets under the new authority; 3) all other credit unions lend an amount equal to their current "use rate". Estimates arrived at using these assumptions are further adjusted as follows: a) credit unions with net worth/assets <= 6% are assumed to have no growth; b) credit unions with 6% to 7% net worth remain at the current 12.25% cap; c) credit unions with 10%+ MBL/assets are limited to a 30% increase in the first year. The first-year increase is equal to 40% of the new "use rate". Assumptions for increased employment are based on the Council of Economic Advisors May 2009 *American Recovery and Reinvestment Act* job creation estimates ($92,000 in spending creates one job).

[3] FDIC, NCUA and CUNA Policy Analysis.

many credit unions even capped portfolios under current law are not large enough to justify the sizeable up-front investment necessary to provide this service.

The bank lobby also complains that business lending is not a part of the credit union mission. Unfortunately, they ignore three important facts:

- First, credit unions were created to meet the credit needs of their members – all of them, even the ones that own small businesses.
- Second, credit unions have been engaging in safe and sound business lending since their inception in the United States more than 100 years ago; in fact, some of the first loans credit unions ever made were for business purposes.
- And third, much like consumers needed access to credit following the Great Depression, today small business-owning credit union members are in need of access to credit, which credit unions stand ready to provide if Congress acts.

Finally, the bank lobby would like Congress to believe that credit unions do not have the experience to do this type of lending safely and soundly. The facts suggest just the opposite: credit unions, which are not-for-profit, have demonstrated the ability to do this type of lending safely and soundly, especially in comparison to for-profit bank lenders.

Since 1998, credit union member business loan net charge-offs have averaged an incredibly low 0.26%. Of course, business lending is subject to the fluctuations of the business cycle, so the Great Recession saw an increase in both delinquencies and net charge-offs in credit union business loan portfolios. However, in the first half of 2011, the credit union member business loan net charge-off rate of 0.81% remained lower than the net charge-off rate on credit union consumer loans (1.36%) and also was lower than the net charge-off rate on total credit union loans (0.95%).[4]

Credit union business lending also reflects substantially greater strength than business lending at other financial institutions. Since 1997, credit union member business loan net charge-offs rates have been roughly one-fourth the bank average (0.23% vs. 0.90%). Additionally, in 2010, credit union MBL net charge-offs averaged less than one-half the bank rate (0.74% vs. 1.75%), and in the first half of 2011 credit union MBL annualized net charge-offs remained lower than the bank rate (0.81% vs. 0.86%) even though the bank rate declined dramatically in the period.[5]

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[4] NCUA and CUNA Policy Analysis.

[5] FDIC, NCUA and CUNA Policy Analysis.

The Honorable Scott Garrett
The Honorable Maxine Waters
September 20, 2011
Page Four

We understand that your subcommittee does not have jurisdiction over H.R. 1418. However, any serious discussion of access to capital must include credit union business lending and the restrictions Congress placed on such lending in 1998. It is clear that credit unions have a history of safe and sound lending, have consumer demand for our products (as evidenced through our growth), and have a willingness to help small businesses owners weather the current economic situation.

On behalf of America's credit unions and their 93 million members, thank you very much for considering our views.

Best regards,

Bill Cheney
President & CEO

ICBA
INDEPENDENT COMMUNITY
BANKERS of AMERICA®

September 21, 2011

Regulatory Relief Essential for Small Business Capital Formation

On behalf of its nearly 5,000 community bank members, ICBA is pleased to submit this statement for the record on "Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation." We appreciate your commitment to small businesses and are pleased to offer ICBA's perspective.

Community banks are prolific lenders to small businesses, funding nearly 60 percent of all small business loan balances as of the first quarter 2011. Recent Federal Reserve Bank research shows that while overall small business lending contracted during the recent recession, lending by a majority of community banks actually increased.

Increase the SEC Shareholder Registration Threshold (H.R. 1965 / H.R. 2167)

Community banks must have access to equity markets without tripping the SEC registration requirement that brings with it very expensive regulatory compliance costs including legal and accounting fees. As bank regulators demand higher capital levels, community banks must be able to raise capital from more shareholders without SEC registration. H.R. 1965, introduced by Reps. Jim Himes (D-CT) and Steve Womack (R-AR), would provide relief from the registration requirement by raising the threshold that triggers registration from 500 shareholders to 2,000. ICBA strongly supports H.R. 1965.

The 500 shareholder threshold has been law since 1964 when Section 12(g) was added to the Exchange Act of 1934 and has not been raised since that time. Community banks that register must comply with the same quarterly and annual reporting requirements, proxy solicitation, and insider trading requirements applicable to the very largest companies listed on an exchange. Registered companies are also subject to the Sarbanes-Oxley 404(a) requirement that management certify internal controls. Registration involves significant legal and accounting expenses for a small company of approximately $100,000 initially and $50,000 annually thereafter. The expense is disproportionately large for community banks because they do not have the scale of larger institutions which are able to spread legal and compliance costs. Due to new requirements, such as SOX 404(a), these costs have increased significantly in real terms since 1964, altering the cost-benefit ratio which was the basis for the original threshold. An update to the threshold is warranted and can be accomplished without increasing investor risk.

H.R. 1965 would also raise the SEC deregistration threshold from 300 to 1200, making it easier for registered community banks to deregister following a stock buyback or consolidation of shareholders. A company that has registered should have a reasonable opportunity to deregister and reduce unproductive expenses. ICBA believes it makes sense to increase both the SEC registration and deregistration thresholds, and we are pleased that H.R. 1965 reforms both thresholds.

We would also like to comment on another approach to revising the shareholder threshold, Rep. David Schweikert's (R-AZ) Private Company Flexibility and Growth Act (H.R. 2167). H.R. 2167 would raise the threshold to 1,000 for all companies and would not count "accredited investors" (as defined by the SEC) or individuals who received shares as part of an employee compensation plan against the threshold. ICBA appreciates H.R. 2167 as a significant improvement over current law. Exempting accredited investors and employee shareholders from the threshold makes sense because the purpose of the registration requirement is to protect unsophisticated, outside investors. If we offer one suggestion to add to H.R. 2167, in addition to raising the registration threshold, we would support increasing the deregistration threshold for the reasons discussed above. H.R. 2167 currently makes no change to the deregistration threshold.

Increase Sarbanes-Oxley 404(b) Exemption

Another burden faced by community banks is the internal control attestation requirement of Sarbanes-Oxley 404(b). Because community banks have their internal control systems monitored continually by bank examiners, they should not have to sustain the unnecessary annual expense of paying an outside audit firm to prepare these reports.

ICBA strongly supports Rep. Fincher's draft legislation, to be considered at today's hearing, which would expand the Section 404(b) exemption. Rep. Fincher's draft bill would exempt all companies with a market capitalization of $500 million or less, a significant increase over the current threshold of $75 million. Companies with market capitalization between $500 million and $1 billion would be permitted to opt-out of Section 404(b) compliance by a majority vote of shareholders. A company within this capitalization range that has complied with Section 404(b) before enactment would be able to conduct a shareholder vote and potentially opt-out immediately, while a company that registers with the SEC after enactment would be allowed to defer compliance for five years and then conduct a shareholder vote on opting out.

The current exemption threshold of $75 million is far too low to provide meaningful relief for public companies. Rep. Fincher's draft bill would relieve more community banks and other public companies of a regulatory burden and expense without creating more risk for investors.

Thank you again for the opportunity to submit this statement for the record. We look forward to working with this committee to advance legislation to provide relief from the SEC registration requirement, the Sarbanes-Oxley 404(b) internal control attestation requirement, and other legislative proposals that would increase access to capital for America's small businesses.

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CHAMBER OF COMMERCE
OF THE
UNITED STATES OF AMERICA

R. BRUCE JOSTEN
EXECUTIVE VICE PRESIDENT
GOVERNMENT AFFAIRS

1615 H STREET, N.W.
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202/463-5310

September 20, 2011

The Honorable Scott Garrett
Chairman
Subcommittee on Capital Markets and
Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
Subcommittee on Capital Markets and
Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Garrett and Ranking Member Waters:

The U.S. Chamber of Commerce, the world's largest business federation representing the interests of more than three million businesses and organizations of every size, sector, and region, strongly support H.R. 1965, "To amend the securities laws to establish certain thresholds for shareholder registration, and for other purposes;" H.R. 2167, the "Private Company Flexibility and Growth Act;" H.R. 2930, the "Entrepreneur Access to Capital Act;" and H.R. 2940, the "Access to Capital for Job Creators Act." These bills would enhance capital formation needed to build new businesses, expand existing businesses and create jobs. The Chamber urges the Subcommittee to report these bills to the full House in the near term.

H.R. 1965 would raise the Exchange Act's shareholder cap from 499 to 1,999 shareholders for banks and permits banks with less than 1,200 shareholders to cease reporting requirements under the Exchange Act. This legislation would increase banks' ability to raise capital from a larger shareholder base, which would creates a level playing field for smaller community banks.

H.R. 2167 would raise the Exchange Act's cap on shareholders from 499 to 999 and provide that accredited investors and employees that received securities pursuant to an employee compensation plan do not count towards the cap. This bill would increase the ability of all companies to raise capital from a larger base of shareholders and would facilitate investments by employees and accredited investors, who do not need heightened protections from the Exchange Act's provisions.

H.R. 2930 would establish a new Securities Act exemption for small investments in small issuances, regardless of investors' accredited status, and exclude investors in such issuances from the Exchange Act's 499 shareholder cap. This legislation would open up opportunities for small investors to make investments in small businesses.

H.R. 2940 would remove the prohibition on general solicitation or general advertising for certain small issuances, provided that all purchasers of the securities are accredited investors. This bill would give flexibility to companies to raise capital from accredited investors who do not need heightened protections from the Exchange Act's provisions.

The Chamber supports these bills because they would assist capital formation, particularly for small businesses, at a time when robust economic growth and job formation are urgently needed. The Chamber strongly urges the Subcommittee to report H.R. 1965, H.R. 2167, H.R. 2930 and H.R. 2940 as expeditiously as possible.

Sincerely,

R. Bruce Josten

cc: Members of the Subcommittee on Capital Markets and Government Sponsored Enterprises

CFA INSTITUTE — CENTER FOR AUDIT QUALITY Serving Investors, Public Company Auditors & the Markets — Council of Institutional Investors

September 20, 2011

The Honorable Spencer Bachus
Chairman
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Barney Frank
Ranking Member
House Financial Services Committee
B371A Rayburn House Office Building
Washington, DC 20515

Dear Chairman Bachus and Ranking Member Frank:

We understand that the Committee is considering legislation that could weaken certain investor protections of the Sarbanes-Oxley Act of 2002 (SOX). The Center for Audit Quality, the Council for Institutional Investors, and CFA Institute are writing to urge you to resist efforts to further weaken SOX by exempting even more public companies from compliance with Section 404(b) of the Act, which requires an independent audit of a company's assessment of its internal controls as a component of its financial statement audit.

Indeed, effective internal controls have become more central to the financial statement audit, a fact that has contributed to an increase in overall audit quality in the years since the passage of the Sarbanes-Oxley Act.

The processes associated with attesting to a company's internal control effectiveness have become more integrated into the financial statement audit and, as a result, are more cost-efficient than in the early days of Sarbanes-Oxley Act implementation. Additionally, the original PCAOB standard that implemented auditor attestation of effective internal controls (AS2) was revised in 2007 to allow for greater efficiencies, and the SEC also issued guidance to management on implementation of Section 404, both of which contributed significant cost savings after the first few years of SOX implementation.

While we recognize efforts to address redundant and unnecessary regulation that provides little value, we believe effective internal controls to be a critical component of the financial statement audit. The financial statement audit, in turn, continues to be important to well-functioning capital markets by improving the quality of, and confidence in, the financial reports provided to investors and other stakeholders.

In fact, in a 2010 CAQ survey[1], two-thirds of the nation's individual investors made clear their concern about exempting smaller public companies from Section 404(b). Further, 8 in 10 of those investors were uneasy over the possibility that the Congress may consider extending the exemption to larger companies.

[1] Center for Audit Quality, "2010 Main Street Investors Survey," http://www.thecaq.org/newsroom/pdfs/2010SummaryInvestorSurvey.pdf, September 9, 2010.

As you know, Section 989G(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the Securities and Exchange Commission (SEC) to conduct a study to determine how the SEC could reduce the burden of complying with Section 404(b) for companies whose market capitalization is between $75 and $250 million, while at the same time maintaining investor protection. In the resulting study, published last April[2], the SEC concluded that the existing requirements for issuers with a $75-$250 million public float to comply with the auditor attestation provisions of Section 404(b) should be maintained and that no new exemptions should be granted. Specifically, the SEC found that, "There is strong evidence that the auditor's role in auditing the effectiveness of ICFR [Internal Control for Financial Reporting] improves the reliability of internal control disclosures and financial reporting overall and is useful to investors. The Commission's staff also determined that over time the costs and burdens of Section 404(b) compliance have declined and that eliminating them would not "justify the loss of investor protections and benefits to issuers..."

Additionally, other research has underscored the benefits of an independent audit of a public company's internal controls:

- The authors of a 2011 paper on "The Effect of Voluntary Internal Control Audits on the Cost of Capital" concluded that companies that voluntarily comply with Section 404(b) enjoy a lower cost of capital and enjoy a decline in the cost of equity and debt capital in the first year of compliance. "Our findings are important because they demonstrate an important benefit that small companies can derive from purchasing internal control audits," they wrote.[3]

- Based on survey responses from more than 3,000 individuals, a 2010 paper concluded that, "the common view that Section 404 adds layers of financial reporting procedures to no avail seems to be overstated, and the evidence indicates that standardization by regulatory intervention is beneficial, as attested by the decrease in reported costs and concomitant increase in perceived net benefits following the 2007 reforms, regardless of company size."[4]

- Another researcher described as problematic the likelihood that exempting smaller reporting companies from Section 404 will significantly increase the information asymmetry between smaller reporting companies and their investors, "since ordinary shareholders are the

[2] Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between $75 and $250 Million, U.S. Securities and Exchange Commission, http://www.sec.gov/news/studies/2011/404bfloat-study.pdf, April 2011.

[3] "The Effect of Voluntary Internal Control Audits on the Cost of Capital," Cassell, Myers and Zhou, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1734300, January 2, 2011.

[4] "The Economic Effects of SOX Section 404 Compliance: A Corporate Insider Perspective," Alexander, Bauguess, Bernile, Lee, and Marietta-Westberg, http://apps.olin.wustl.edu/FIRS/PDF/2010/1608.pdf, March 2010.

predominant external shareholders for smaller reporting companies and have historically demonstrated themselves to be vulnerable to just this type of information asymmetry." [5]

- In addition, a 2010 survey by the consulting firm Protivity found that a significant majority (70 percent) of executives experienced with SOX Section 404 compliance believe the benefits outweigh the costs.[6]

In the final analysis, we believe that <u>all</u> investors should receive equal protections with respect to the effectiveness of internal control over financial reporting by publicly traded companies. Like you, we recognize the positive impact small businesses have on the economy and job creation. However, we cannot support actions, no matter how well intentioned, that threaten investor confidence and the stability of the U.S. capital markets.

We therefore remain firmly committed to retention of 404(b) to the fullest extent.

Sincerely,

Kurt Schacht	Cindy Fornelli	Jeff Mahoney
Managing Director	Executive Director	General Counsel
CFA Institute	Center for Audit Quality	Council of Institutional Investors

cc: The Honorable Tim Johnson, Chair, Senate Banking Committee
The Honorable Richard Shelby, Ranking Member, Senate Banking Committee

[5] "The Case Against Exempting Smaller Reporting Companies from Sarbanes-Oxley Section 404: Why Market-Based Solutions are Likely to Harm Ordinary Investors," Orcutt, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1421844, 2009.

[6] "Where U.S.-Listed Companies Stand: Reviewing Cost, Time, Effort and Processes," 2011 Sarbanes-Oxley Compliance Survey, http://www.protiviti.com/en-US/Insights/Browse-by-Content/Surveys/Pages/2010-Sarbanes-Oxley-Compliance-Survey.aspx, Protivity Inc., June 2011.