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at

Hearings Before the Senate Committee on Banking, Housing and Urban Affairs

“Spurring Job Growth Through Capital Formation While Protecting Investors”

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Chairman Johnson, Ranking Member Shelby and Fellow Members of the Committee:

I am happy to be here today and appreciate the balanced approach that the title for these hearings reflects. We want at the same time to spur job growth and minimize any sacrifice of investor protection. I support the intent of the bills now pending before the Senate to facilitate smaller offerings at low cost (particularly S.1544 and S.1831). Still, without some changes (which are essentially modest), one of these bills (S.1791) could well be titled “The Boiler Room Legalization Act of 2011.” Of even greater concern to me is the overbreadth inherent in S.1824, which pushes up the threshold at which an issuer must become a “reporting company” and make periodic disclosures to the market to 2,000 shareholders of record. I can understand the case for increasing the threshold under Section 12(g), but the problem with the approach taken is that record ownership is easily manipulated and companies could come to have 5,000 or more beneficial shareholders (and billions in stock market capitalization) without becoming subject to the increased transparency of the Securities and Exchange Act of 1934. There is no need for such an open-ended exemption (largely benefitting larger firms) or for such a dramatic retreat from the principle of transparency that has long governed our securities markets in order to spur job creation at smaller firms.

I. Introduction

In a nutshell, let me define the contours of the dilemma. There is considerable reason to believe that smaller businesses disproportionately create jobs. But smaller businesses have been increasingly shut out from access to the public equity markets. Although smaller IPOs (usually defined as IPOs of under \$50 million) once accounted for as much as 80% of all IPOs, that pattern changed abruptly in the late 1990s. Since then,

smaller IPOs (again defined as those seeking to raise less than \$50 million) have constituted less than 20% of the number of all IPOs.¹ This pattern is unlikely to change. Much as some wish we could turn the clock back to the mid-1990s, the smaller IPO has largely disappeared for a variety of reasons, including:

- (1) There are high fixed costs to an IPO. The greater the size of an offering, the less these fixed costs – for lawyers, accountants, offering expenses, etc. – represent as a percentage of the total offering. Hence, small IPOs are an economically inefficient way to raise capital;
- (2) Institutional investors are the primary buyers of IPOs, but institutional investors want secondary market liquidity, and they can rarely obtain such liquidity unless the market capitalization of the IPO issuer is equal to \$500 million or more;
- (3) The market infrastructure that supported smaller IPOs, including multiple securities analysts following and supporting the stock, is largely gone, and smaller IPOs may not be followed by any analyst; and
- (4) The retail public still remembers the Internet bubble of 2000 and the Enron/WorldCom scandals of 2001-2002. Once investor confidence is lost (because of conflicted analysts, offering hyperbole, and dubious financial statements), it is not easily recovered.

A final reason why smaller IPOs have declined is that smaller issuers have found it easier, quicker, and less costly to raise capital in the private markets than in the public

¹ See Statement of David Weild before the House Financial Services Committee, Subcommittee on Capital Markets and Government Sponsored Enterprises, on March 18, 2011. See also Grant Thornton, “Stock Markets, Capital Formation and Job Creation Under Attack” (2011).

markets. Smaller issuers prefer to avoid the higher liability and greater SEC oversight that is associated with public offerings. Accelerating this shift from public to private markets was the gradual relaxation of SEC Rule 144's holding period for "restricted securities" issued in private placements. In early 1997, the SEC amended Rule 144 so that the purchaser of "restricted securities" could resell them into the public market after an only one year holding period (as opposed to the prior two year holding period rule), and almost immediately thereafter smaller public offerings fell off dramatically, crashing from over 75% of the number of all IPOs in 1996 to less than 20% in 1998.

This shift toward the private market has continued and accelerated. In 2010, SEC Commissioner Elisse Walter estimated last month that over \$900 billion in securities were sold pursuant to Regulation D (which is the primary SEC rule exempting private placements from registration under the Securities Act of 1933). Similarly, the SEC's Chief Economist has recently estimated that, since the beginning of 2009, there have been some 37,000 Regulation D offerings reported to the SEC² (and in all likelihood this underestimates the use of Regulation D because many such offerings are not reported to the SEC). The median size of these offerings was approximately \$1 million. Thus, the implication seems clear: smaller issuers have displayed a marked preference for private offerings, and this preference is likely to persist.

II. The Pending Bills

This introduction sets the stage for my comments on the bills before this Committee. Basically, I believe that S.1544 and S.1831 are useful efforts to facilitate exempt offerings. Although I have some skepticism about whether they will significantly

² See Craig Lewis, "Unregistered Offerings and the Regulation D Exemption" (2011) (Powerpoint slides).

increase or expedite the raising of capital, they do not sacrifice investor protection. In contrast, S.1791 is an innovative effort to facilitate the raising of small amounts of capital from retail investors. Although we all want to be Internet-friendly, S.1791, in its present form, seems likely to invite a significant amount of fraud that could, over the longer run, stigmatize those attempting to market smaller offerings. Still, with some adjustments that would not raise the costs of such an offering procedure, I believe that the potential for fraud and “boiler room” marketing could be substantially curtailed. Finally, S.1824 seeks to delay the point at which smaller companies must become “reporting” companies under the Securities Exchange Act. This is understandable, but the approach it takes is overbroad and it could permit some very large companies (i) to avoid the transparency and periodic disclosure mandated by the Securities Exchange Act, or (ii) to “go dark” (that is, cease to become reporting companies), even though they had already become reporting companies and had a significant market capitalizations, shareholder populations, and trading volumes. This is unnecessary, but again a small revision could reduce this potential, while still enabling smaller companies to avoid these costs.

A. S.1544 (“The Small Company Capital Formation Act of 2011”). This legislation raises the ceiling on the exemption for small issues under Section 3(b) of the Securities Act of 1933 from \$5 billion to \$50 million. This provision strikes me as balanced and well-crafted because at the same time as it raises the ceiling under Section 3(b), it adds additional investor protections, including (1) a clearly specified litigation remedy (Section 12(a)(2)); and (2) audited financial statements. As before, an offering statement would be filed with the Commission, and periodic disclosure would be required to the extent that the Commission directs.

In sum, investors receive (1) SEC oversight; (2) a detailed disclosure document; (3) continuing periodic disclosure; and (4) a negligence-based litigation remedy that roughly approximates the remedy that they would receive in a registered public offering.

Two aspects of S.1544 do give me some concern. First, Section 2(b) of S.1544 would deem securities sold in certain offerings under Section 3(b) to be “covered securities” and hence exempt from registration with state “Blue Sky” commissioners (at least if the securities are sold to a “qualified purchaser” as defined by the SEC). It is unclear how the Commission will use this authority (and the Commission could preclude offerings to unsophisticated investors as the price of escaping Blue Sky regulation). Although I recognize that smaller offerings tend to fly under the SEC’s radar screen and to be principally monitored by the Blue Sky commissioners, S.1544 does permit these Blue Sky commissioners to retain their antifraud authority under Section 18(c) of the Securities Act. Thus, it is only their authority to require registration of the offering that is preempted. This presents a close question.

In evaluating whether it is desirable to preempt state registration of offerings under Section 3(b), this Committee may want to consider the very limited incentive that today exists to use this Section 3(b) exemption. I have been advised by SEC staffers that in 2010 only seven offerings went effective under Regulation A (which is based on Section 3(b)). Most issuers saw Section 3(b) as unattractive (in comparison to a private placement under Regulation D) both because of Section 3(b)’s low ceiling (i.e., \$5 million) and the need to file an offering document that is reviewed by the SEC. Raising the ceiling to \$50 million does not necessarily imply that this provision, as revised, will be more attractive than Rule 506 under Regulation D (which has no ceiling on the

amount that may be offered and does not require SEC approval of the offering document). I suspect that Regulation D will remain far more popular than Regulation A, even with the revised ceiling on Regulation A. In this light, preempting state registration of Regulation A offerings may represent an additional, but small, step towards increasing the attractiveness of a Regulation A offering. Unlike Regulation D, Regulation A offerings may today be marketed to retail investors (and without any limit on their number), and a general solicitation of investors is possible. Thus, its use could increase, but frankly I am skeptical that there will be any dramatic rise in its use.

A second concern relates to the authority given the SEC by Section 2(a)(5) of S.1544, which authorizes the Commission to increase the ceiling on the Section 3(b) exemption and instructs the Commission to review this matter every two years. This authority is open-ended, and conceivably a future Commission could increase the Section 3(b) ceiling from \$50 million to \$500 million. I suggest it would be advisable to limit this authority to some form of inflation indexing.

B. S.1831 (the “Access to Capital for Job Creators Act”). I believe this to be the least controversial of the bills now pending before this Committee. Its intent is to simplify the private placement process and allow issuers to contact a broader range of investors by eliminating the existing ban on general solicitation (at least in cases when only accredited investors are solicited). See SEC Rule 502(c) (prohibiting a general solicitation or general advertising under Rules 505 and 506 of Regulation D). This idea is hardly radical, as the SEC in past years has discussed the possibility of deleting the general solicitation prohibition. The rationale for this change would be the same that

governs in the NBA: “No Harm, No Foul.” Accredited investors are deemed to be sophisticated, and thus a general solicitation of them harms no one – in theory.

Of course, this theory may be overbroad in that many accredited investors are unsophisticated and even naïve. The standard for an accredited investor is only \$1 million in net worth or a \$200,000 income for the most recent two years (see SEC Rule 501(a)(5) and (6)). Thus, much of the American middle class is reached by this term. Nonetheless, this proposed revision will simplify private placements and allow smaller issuers to reach more investors at low cost. In that sense, its benefits may exceed its costs.

But there is a serious problem with the drafting of S.1831, at least if the intent is simply to allow a general solicitation of accredited investors. Section 2(a) of S.1831 would revise Section 4(a) of the Securities Act of 1933 to read as follows:

“(a) transactions by an issuer not involving any public offering, whether or not such transactions involve general solicitation or general advertising.”

Section 2(b) then instructs the SEC to revise its rules to permit a general solicitation in connection with a Rule 506 “provided that all purchasers of the securities are accredited investors.”

The problem here is that Section 2(a) covers with a blanket what Section 2(b) wants the SEC to cover only with a napkin. The plain meaning of the language of Section 4(2), as revised by Section 2(a) of S.1831, is to permit a general solicitation in all private placements, including those not restricted to accredited investors. Both the Supreme Court and the D.C. Circuit Court of Appeals have shown, time and time again, that they will focus on the plain meaning of the statutory language and ignore legislative history.

Thus, I would suggest that, if Section 4(2) is to be revised at all (and a statutory revision of it is not really necessary, given Section 2(b)), it should be amended to read:

“(a) transactions by an issuer not involving any public offering, including transactions involving a general solicitation or general advertising to the extent such solicitation or advertising is permitted by rules or regulations adopted by the Commission.”

The Commission could still be instructed by Section 2(b) as to how to exercise its discretion in this regard. Alternatively, no change need be made at all in Section 4(2) of the Securities Act, as Section 2(b) alone should be sufficient.

C. S.1791 (“Democratizing Access to Capital Act of 2011”). This bill has an innovative premise: namely, to allow issuers to solicit retail investors through the Internet without providing any meaningful disclosure document and without prior SEC oversight, so long as the amount that may be sold to each investor is small. Under S.1791, no individual investor could invest more than \$1,000 in such an offering.³ Presumably, such offerings would remain subject to Rule 10b-5 (because no antifraud exemption is provided).

Because the maximum aggregate amount that may be raised in any 12-month period is \$1 million, this exemption is likely to be used primarily by early stage issuers that do not yet have an operating history or, possibly, even financial statements. Such issuers are in effect flying on a “wing and a prayer,” selling hope more than substance. Precisely because of this profile, however, such offerings are uniquely subject to fraud, and some issuers will simply be phantom companies without any assets, business model, or real world existence.

To enable these early stage issuers to seek small investors, S.1791 confers both an exemption from offering registration under Section 5 of the Securities Act and an exemption from broker registration under the Securities Exchange Act. Of these two

³ The House bill, however, provides a \$10,000 ceiling on individual investor purchases.

exemptions, the latter should be of greater concern, because it offers unparalleled opportunities for the traditional boiler room operation to reemerge.

To understand this point, let's focus on how fraudsters could most easily exploit this exemption from broker-dealer registration. Unlicensed salesmen (some of whom might have been banned for life from the securities industry) could set up shop and solicit potential investors by phone, email, or face-to-face contacts. They could create very short profiles of phantom companies, display them on a website, invite customers to view them, and then seek "hard sell" follow-up meetings. Even though a single customer could not invest more than \$1,000 in any single company, such a customer could be induced by salesmen to invest in five or six different companies. The salesmen's motivation could be either to pocket the entire proceeds received from the investors (telling them, if later questioned, that the business failed) or to deduct an inflated sales commission from the investor's payment for shares.

How is the prospect for such fraud best limited without also precluding a "crowdfunding" solicitation? I suggest the best strategy is two pronged: (1) keep the website (or "crowdfunding intermediary" in S.1871's terminology) largely passive; that is, do not permit to engage in any active solicitation beyond display of the issuer's offering materials on its website; and (2) require those who engage in active solicitation of investors (by any means other than a passive website) to register as broker-dealers. Thus, the "broker and dealer exemption" in Section 7 of S.1791 should be limited so that it applies to a website that does not itself allow its employees to solicit sales or that does not pay outside agents to do so. The issuer could, of course, pay agents to solicit, but they would have to be registered brokers. This approach allows a "crowdfunding

intermediary” to serve as a conduit for the issuer’s offering materials without registration as a broker, but it confines this unregistered intermediary to a passive role. Active selling would be limited to registered brokers (who are subject to the oversight of FINRA and SEC rules regarding brokers).

Failure to adopt this approach (or some similar variant) would likely mean that every barroom in America could become a securities market, as some unregistered salesman, vaguely resembling Danny DeVito, could set up shop to market securities under the “crowdfunding exemption.” Under the current version of S.1791, such a person could open his laptop on the bar, show slides of a half dozen companies to the bar’s patrons, and solicit sales. This will create few jobs (except for dubious unregistered salesmen) and much fraud.

If this Committee decided that it wanted to restrict active securities solicitations by a “crowdfunding intermediary,” the simplest way to do so would be to expand the proposed language in Section 7 of S.1791, which language would amend Section 3(a)(4) of the Securities Exchange Act of 1934. Proposed Section 3(a)(4)(G)(ii)VII could be revised to read:

“(VII) does not (a) offer investment advice or recommendations, (b) solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal, or (c) compensate employees, agents, or other third parties for such solicitation or based on the sale of securities displayed or referenced on its website or portal.”

This language is intended to permit an exempt intermediary to display the issuer’s offering materials but not otherwise to solicit sales, leaving that task for registered brokers.

One last comment about the proposed “crowdfunding exemption”: the existing language in S.1791 does not address the SEC’s integration doctrine. An issuer who utilizes proposed Section 4(6) to make a \$1 million offering might cause the issuer to sacrifice its ability to make an exempt offering under some other exemption for a period beginning six months before the start of, and extending until six months after the end of, the crowdfunding offering. See SEC Rule 502(a) (defining the general contours of the integration doctrine and employing a six month safe harbor before and after the offering). See also Securities Act Release No. 33-4552 (November 6, 2962). To prevent this, a section might be added to S.1791 instructing the Commission to adopt rules to ensure that use of the “crowdfunding exemption” in Section 4(6) will not cause the issuer to forfeit other exemptions.

D. S.1824 (the “Private Company Flexibility and Growth Act”). This bill is intended to delay the point at which a company must become a “reporting” company under Section 12(g) of the Securities Exchange Act (and thus required to make periodic disclosures to the market on at least a quarterly basis). Specifically, it would raise the limit from 500 shareholders of record (on the last day of the issuer’s fiscal year) to 2,000 such record holders (as of the same moment). The offered rationale for this change is, at least in part, that many private companies have been delayed in their ability to consummate an IPO, and this delay has forced their employees holding stock options to either exercise (and become shareholders of record) or let the options expire. As a result, some private companies (most notably Facebook) are approaching the 500 shareholder limit before their likely IPO date.

There are several obvious solutions to this problem. First, one could simply exempt securities held by employees from this computation, and Section 3 of S.1824 does this. Second, shareholders in these companies could hold shares beneficially (and not of record) by using a broker or bank as an intermediary. Such “street name” ownership is today the prevalent mode of ownership in public companies.

The problem with expanding the threshold for reporting status under Section 12(g) of the Securities Exchange Act is that record ownership is outdated – in effect, a relic of a bygone era. Using a 2,000 shareholder of record ceiling would enable some companies to remain “dark” (i.e., not to enter the SEC’s continuous disclosure system), even if they had total assets in the billions of dollars and possibly 10,000 beneficial shareholders. In short, companies could exploit this provision by insisting that shareholders hold their stock only in “street name” (or by repurchasing the shares of those unwilling to do so).

In addition, proposed Section 5 of S.1824 would permit a bank or bank holding company that was already a “reporting” company to deregister under Section 12(g)(4) of the Securities Exchange Act (and thus “go dark” in the parlance) if it could cause the number of its shareholders to fall below 1200 shareholders of record. Again, this could be manipulated by inducing shareholders to hold in street name.

The federal securities laws have insisted upon transparency on the part of a company with a substantial number of shareholders since 1964. In 1964, “shareholders of record” was a meaningful concept; today it no longer is. The proposed language is a threat to that principle of transparency. Put simply, “going dark” invites bad things: undisclosed self-dealing, conflicts of interest, etc. Some companies might also wish to go

dark to avoid the Foreign Corrupt Practices Act (some of whose provisions apply only to reporting companies).

I do not suggest that the 500 shareholder threshold is immutable and cannot be revised. The real problem is that the “shareholder of record” concept is archaic and can be gamed. A superior test would look to the size of the company’s “public float” (i.e., the value of the securities held by non-affiliates) in order to determine whether the company should enter the SEC’s continuous disclosure system. This public float test has been used by the SEC in determining eligibility for Form S-3 and is easily calculated. Although it is impractical to compute the number of a company’s beneficial holders, it is very simple to compute its “public float.” Under such a test, it would make no difference whether shares were held beneficially or of record. But the value of stock held by affiliates and controlling persons would not be counted, thus permitting family-controlled companies to remain private.

Of course, a compromise is possible here: a shareholder of record test could be used, subject to a proviso that a company with a specified market capitalization held by non-affiliated shareholders would still have to become a reporting company. Thus, the relevant lines in Section 12(g)(1) of the Securities Exchange Act might require an issuer to register under it when:

“the issuer has total assets exceeding \$10,000,000 and a class of equity securities (other than an exempted security) held of record by 2,000 persons; provided however, that, without regard to the number of its shareholders of record, an issuer with a class of equity having a market value on the last day of its fiscal year (excluding for this purpose the value of such shares held by affiliates of the company) in excess of \$[500 million] shall be required to register under this section within 120 days after the end of such fiscal year.”

This approach simply says that at some point a company which has successfully kept its shares in beneficial ownership through the use of brokers or other intermediaries will still have to register and become a “reporting” company. My use of a \$500 million threshold is simply for purposes of illustration (as, I believe, few could quarrel with a threshold that high).