Record of Proceedings

30^{th} Annual SEC Government-Business

Forum on Small Business Capital Formation

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Call to Order

Gerald Laporte: If everyone will take their seats, I think we're ready to begin the program. Good morning. My name is Gerry Laporte. I'm Chief of the Office of Small Business Policy in the SEC's Division of Corporation Finance. I'm here to call to order the 30th annual SEC Government-Business Forum on Small Business Capital Formation. This event is being conducted under the mandate of Section 503 of the Omnibus Small Business Capital Formation Act of 1980. Before we begin, on behalf of each person from the SEC who will speak during today's program, I want to say that the views that they express here are their own and don't necessarily represent the views of any other person from the SEC or the views of the agency itself. Since we've got a very heavy schedule this morning, I'm going to get right down to the point and introduce Meredith Cross, the Director of the SEC's Division of Corporation Finance. That division is the part of the SEC that's most responsible for the Commission's conduct of the Forum on Small Business Capital Formation every year. Meredith has been Director of our division for a little over two years now. She came to us from the law firm of WilmerHale, where she had practiced law for 11 years, after previously spending eight years at the SEC in the Division of Corporation Finance. Meredith has a very broad and deep understanding of the issues the SEC faces relating to small business capital formation, partially because, when she was here before, she supervised the Office of Small Business Policy, in which I now work. Meredith?

Introduction of Chairman

Meredith Cross: Good morning everyone. Thank you, Gerry. I would like to also welcome you and thank you for taking the time to be here with us today and sharing your experience and insights with the Commission and with the public. As Gerry mentioned, this is the 30th annual forum, a wonderful event addressing a topic that's very important to the Division of Corporation Finance and to the Commission as a whole. I know the staff in my division is particularly interested to hear your thoughts on the issues at hand, because we are hard at work on several work streams relating to the topics on today's agenda. Lona Nallengara and I will each speak a bit later about these work streams, but I first have the honor of introducing the Chairman of the SEC, Mary Schapiro, to open the forum.

Chairman Schapiro rejoined the SEC in January 2009, having previously served as a Commissioner in the late '80s and early '90s. I was fortunate to work with her then, and I'm so pleased to be working with her again now. She left the SEC to become Chairman of the Commodity Futures Trading Commission in 1994, and then joined NASD, the predecessor to FINRA, the Financial Industry Regulatory Authority, where she rose to become CEO before coming back to the Commission. Chairman Schapiro has navigated the agency through many changes and initiatives during her tenure. I can't say enough about her energy and leadership as we have worked on an agenda designed to restore investor confidence in the markets, which is crucial to ensuring that our markets provide access to capital for businesses large and small. It's now my pleasure to turn the podium over to Chairman Schapiro.

[applause]

Opening Remarks

SEC Chairman Mary Schapiro: Good morning.

Thank you, Meredith, for that kind introduction. And thank you for all the work you and the Corp Fin team have done to make this forum a success, and for helping ensure that the distinct needs of small businesses are front and center at the SEC.

Thanks, also, to all of you who are joining us today as participants in a series of discussions designed to help the SEC better understand one of the most pressing issues facing small businesses: raising the capital these businesses need to expand and grow. I know that your uniformly impressive level of expertise, in combination with the varied backgrounds you bring to this forum, will ensure an interesting and illuminating day.

I would like to welcome all those who are attending here in Washington, viewing by webcast or listening through our teleconference.

And I'd also like to thank Gerry Laporte, Tony Barone and the other staff of the Office of Small Business Policy for their work in organizing this meeting, and for being the voice of small business within the SEC.

Small businesses are important to the SEC—you can get a sense of just how important by the fact that all five commissioners will be speaking today, something that rarely happens outside of Commission meetings.

And, of course, you can find particular concern with the needs and health of small businesses in all quarters today, as the nation works to energize the economic recovery and looks to the small businesses to spark growth in job creation.

As you know, studies suggest that small businesses have created 60-to-80 percent of net new American jobs over the last ten years.

But there is a footnote to that statistic: the most vigorous small business job creation comes from small businesses determined to get much larger. Job growth comes from emerging enterprises trying to grow out of their warehouse space and into a corporate campus or to jump from single downtown location into retail sites nationwide. It comes from companies that need access to capital to make that jump.

Today's focus is on creating an environment in which those small businesses have that access, one in which they can compete successfully for a share of our country's investment capital.

Cost-effective access to capital for companies of all sizes plays a critical role in our national economy, and we believe that companies seeking access to capital should not be overburdened by unnecessary or superfluous regulations.

As we examine ways that the regulatory structure might better facilitate small business capital formation, though, it's important to keep in mind another critical facet of the SEC's mission: investor protection. We must balance the instinct to ease the rules governing capital access with our obligation to protect investors and markets.

This can be a challenge. Even necessary regulation can impose burdens that are disproportionately large for small businesses with limited resources.

As the daughter of a small businessperson, I am familiar with the unique challenges small businesses face. I know that instead of planning year-to-year or quarter-to-quarter, that sometimes it's day-to-day. And I recognize that challenges that a larger business would barely even notice can be significant drains on resources and time to an enterprise that needs to focus everything on making its place in a competitive market.

That is why, when Meredith and I have testified before Congress in recent months on different legislative proposals, we have emphasized the importance of achieving the proper balance.

It's also important to note that investor protection shouldn't just be a priority for investors and their advocates. Confidence in the fairness and honesty of our markets is critical to capital formation. Investors who understand that financial market participants are honest, that disclosures are accurate, and that markets offer a fair chance to earn a reasonable return are more likely to make needed capital available, and demand less in return for doing so.

And so, in this forum and through other efforts, the SEC is seeking strategies for meeting regulatory goals while reducing the weight borne by small businesses.

Over the years, the SEC has taken a number of steps to reduce burdens smaller enterprises face in raising capital: relaxing restrictions on public communications and simplifying disclosure and reporting requirements, for example. But, given the speed with which the financial environment evolves, it is important that we respond when new issues are raised, and that the SEC be willing to re-examine existing regulation in light of changing circumstances.

That is why I have instructed our staff to take a fresh look at some of our offering rules, and to develop ideas for the Commission to consider that would—in a manner consistent with investor protection—reduce undue regulatory constraints on small business capital formation. Among the issues that we are considering are:

- The restrictions on communications in initial public offerings;

- Whether the general solicitation ban should be revisited in light of current technologies, and capital-raising trends;

- The number of shareholders that trigger public reporting, including questions surrounding the use of special purpose vehicles that hold securities for groups of investors; and

- The regulatory questions posed by new capital raising strategies, including crowdfunding.

In conducting this review, we are gathering data and seeking input from many sources, including small businesses, investor groups and the public at large.

In addition, two weeks ago, we convened the first meeting of the SEC's new Advisory Committee on Small and Emerging Companies. This initial meeting has produced a number of insights on these and other relevant issues, from committee members representing businesses, investors, academia and regulators.

As you can see, small business capital formation is an important priority for us.

The re-examination of existing regulations is also of a piece with a goal I set when I returned to the SEC as Chairman: to make sure that the agency was up to date, that the regulations we enforce reflect the current realities of the financial markets.

The role of those of you participating in today's discussions is important to this process. This process and the resulting regulatory decisions must be informed by the "real-world" experience of people who are building a business, raising capital and implementing regulation. Your work providing counsel and becoming a conduit through which others can contribute is vital to the success of our efforts.

Your experience will become a vehicle for better understanding, on our part, of the impact new regulatory arrangements or changes to existing rules might have. You will help us maintain safe, orderly and efficient markets that facilitate capital formation and help businesses grow, while burdening small businesses as little as possible.

For 77 years, the SEC has contributed to small business growth by supporting a capital marketplace in which confident investors invested money in growing businesses. We worked to create a culture of compliance that supported transparent markets marked by high liquidity, strong secondary market trading and investor protection.

We're proud of what we've done. But we recognize that markets and participants change—never faster than in the past two decades—and that regulation must change to reflect those new realities, as well.

With your help, we are working to build a regulatory structure that supports, rather than confines small business growth, while leaving investors confident that their interests in fair and secure financial markets will be protected.

Introduction of Commissioner

Meredith Cross: Thank you very much, Chairman Schapiro. I'm happy to introduce to you now Commissioner Luis Aguilar. Commissioner Aguilar joined the SEC in 2008 and, I'm pleased to report, was just recently reconfirmed for a new term. Commissioner Aguilar brings a

wealth of practical securities law experience to his role at the SEC. Before his appointment he was a partner with the international law firm of McKenna Long & Aldridge. During his career, his practice included matters pertaining to general corporate and business law, international transactions, investment companies and investment advisors, securities law and corporate finance. He also focused on issues related to corporate governance, public and private offerings, mergers and acquisitions, mutual funds, investment advisors, broker-dealers and other aspects of federal and state securities laws and regulations. Commissioner Aguilar's previous experience includes serving as General Counsel, Executive Vice-President and Corporate Secretary of Invesco, and he was Invesco's Managing Director for Latin America in the late 1990s. His career also includes tenure as a partner at prominent national law firms and an earlier tenure as an attorney at the SEC. Commissioner Aguilar represents the Commission as its liaison to both the North American Securities Administrators Association and to the Council of Securities Regulators of the Americas, and he served as the primary sponsor of the SEC's Investor Advisory Committee. We are very pleased that he could be with us here today. Commissioner Aguilar?

Remarks

SEC Commissioner Luis Aguilar: Good morning. First, I would like to welcome all of the distinguished panelists, participants, and attendees to the SEC for today's Government-Business Forum on Small Business Capital Formation. Thank you for inviting me to speak and add my voice to today's dialogue. Second, I also add my thanks to the staff from the Division of Corporation Finance and the Office of Small Business Policy for their work to facilitate today's program. Third, before I start, I must remind you that my remarks represent my own views, and not necessarily those of the Commission, my fellow Commissioners, or members of the staff.

Small business is vital to any nation's economic well-being. I know everyone in this room has been closely following the economic crisis in Europe. I was struck by a recent news article discussing the tragic impact of the crisis on the people of Greece. Specifically, it was reported that "[s]mall shops, in many ways the lifeblood of the Greek economy, which relies on domestic demand, are closing by the day."[1] The European debt crisis reminds us that investors, consumers, entrepreneurs, lenders, underwriters, etc., make up the same economic system, the same market. In this interdependent system, it is essential for all market participants that the fundamentals of this system are strong, fair and transparent.

The principles of a strong, fair and transparent regulatory framework are the defining characteristics of the Federal securities laws. There is no doubt that the system of laws and regulations administered by the SEC has contributed to the United States having the most robust capital market in the world. A key component of the SEC's mission is to facilitate capital formation while at the same time protecting investors. Many studies have demonstrated how

[1] Landon Thomas Jr., Normal Life on Pause, and a Sense of Simmering Rage, N.Y. Times, November 7, 2011, at A5.

regulations fostering investor protections can promote capital formation.[2] For example, a 2003 study showed that the MD&A disclosure required in public company filings under the Exchange Act resulted in more accurate and informed share prices, which contributes to a better functioning real economy.[3] A 2006 study found that the Exchange Act amendments of 1964, which extended disclosure requirements to over-the-counter companies, created substantial value for the shareholders of such companies.[4] Such value creation is central to strong capital formation. We must not forget that investors are the capital providers that drive our capital markets—after all they are writing the checks that make capital formation possible.

And, we need to remember that capital formation is much more than just capital raising. True capital formation requires that funds raised be invested in productive assets. The more productive those assets are, the greater the capital formation facilitated by such investment.[5] Fair disclosure rules level the playing field and help provide investors with the information they need to make reasoned investment decisions. Accordingly, market safeguards that promote reliable disclosure engender the confidence investors need to invest their savings in debt, equity and other securities. The need for full and fair disclosure, so that investors can make investment decisions with the benefit of material information, is a founding principle of the Federal securities laws.[6]

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[2] *See, e.g.*, Frank B. Cross and Robert A. Prentice, The Economic Value of Securities Regulation, 28 Cardozo L. Rev. 333 (2006). *See also* Luis A. Aguilar, Comm'r, U.S. Securities and Exchange Commission, Speech at the Council of Institutional Investors Spring Meeting: Facilitating Real Capital Formation (April 4, 2011) notes 24-26 (available at www.sec.gov/news/speech/2011/spch040411laa.htm#P64_30599); *but cf. id.*, note 20. For the effects of information asymmetry on capital formation, see, George A. Akerlof, The Market for 'Lemons': Quality Uncertainty and the Market Mechanism, The Quarterly Journal of Economics (August 1970) (demonstrating that a lack of adequate information about the quality of an item being purchased can drive a market out of existence: "There may be potential buyers of good quality products and there may be potential sellers of such products in the appropriate price range; however, the presence of people who wish to pawn bad wares as good wares tends to drive out the legitimate business. The cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost also must include the loss incurred from driving legitimate business out of existence.").

[3] Merritt B. Fox, Randall Morck, Bernard Yeung, and Artyom Durnev, Law, Share Price Accuracy, and Economic Performance: The Empirical Evidence, 102 Mich. L. Rev. 331 (2003). The conclusion that more accurate and informed share prices contribute to the real economy references Jeffrey Wurgler, Financial Markets and the Allocation of Capital, 58 J. Fin. Econ. 187 (2000) and Artyom Durnev et al., Value Enhancing Capital Budgeting and Firm-specific Stock Return Variation, 58 J. Fin. 64 (2004). *Id.* notes 86 and 87.

[4] Michael Greenstone, Paul Oyer, and Annette Vissing-Jorgensen, Mandated Disclosure, Stock Returns and the 1964 Securities Acts Amendments, Quarterly Journal of Economics, May 2006 (stating that the "results imply that the 1964 Amendments created . . . $3.2 to $6.2 billion [measured in 2005 dollars] of value for stockholders"). A summary version of the paper is available at http://www.stanford.edu/group/siepr/cgi-bin/siepr/?q=system/files/shared/pubs/papers/briefs/policybrief_jan06.pdf. *See also* Allen Ferrell, Mandated Disclosure and Stock Returns: Evidence from the Over-the-counter Market, 36 J. Legal Studies 1 (2007). An earlier draft is the John M. Olin Center for Law, Economics, and Business Discussion Paper No. 453 (December 2003) (available at http://www.law.harvard.edu/faculty/fferrell/pdfs/Ferrell-MandatedDisclosure2.pdf).

[5] *See, e.g.*, Simon Kuznets, Capital in the American Economy: Its Formation and Financing (Princeton University Press 1961).

[6] *See, e.g.*, Sonesta International Hotels Corp. v. Wellington Associates, 483 F.2d 247 (2nd Cir. 1973) (stating, with respect to Secs. 10(b), 13(d), 14(d), and 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. Secs. 78j(b), 78m(d), 78n(d), and 78n(e) (1971), "[t]hese laws are founded on the principle that full and fair disclosure of all

I look forward to today's dialogue, and to your thoughts as to how we can improve the economic environment for entrepreneurs and investors alike, because smart and workable regulation is a necessary component of a robust capital market and strong capital formation.

Thank you for your participation in today's forum. You have my best wishes for a productive day.

Panel Discussion: Current Capital Formation Issues for Private Companies

Gerald Laporte: Thank you, Commissioner Aguilar. I guess now we can dig in and begin the first panel discussion. I'm going to turn the microphone over to Lona Nallengara, who's been the Deputy Director of Legal and Regulatory Policy at the Division of Corporation since March of 2011, when he joined us from private practice. Lona?

Lona Nallengara: I thank you, Gerry. Our first panel this morning is entitled "Current Capital Formation Issues for Private Companies" and we have a great array of panelists here, and I'll just take a moment to briefly introduce each of our panelists. There's a more detailed summary of their background in the Forum Program that I think you can get at the front of the auditorium, so you should turn to those when you have a moment.

Our co-moderator to my right is a dear friend of all of us, Steve Graham. Steve is the Managing Partner of the Fenwick and West Seattle office, and he's the Co-Chair of the firm's life sciences practice. His practice focuses on representing emerging and established growth companies and investment banks in initial public offerings, and he has a wide array of experience in mergers and acquisition transactions and private offerings of debt and equity, but more importantly for us, Steve is our Co-Chair of the Advisory Committee on Small and Emerging Companies, and we'll hear a little bit about the work of the Advisory Committee later.

Next to Steve is Professor Steve Bradford. Professor Bradford is the Earl Dunlap Distinguished Professor of Law at the University of Nebraska, Lincoln College of Law. He teaches in the areas of securities regulation, corporate law and accounting for lawyers, and he's the author of a number of articles on securities regulation, including his latest article, "Crowdfunding and the Federal Securities Laws", which I recommend to each of you as you're thinking about crowdfunding issues. It's a great article and it's available in our panelist materials on the SEC webpage.

Next to Professor Bradford is Yokum Taku. Yokum is a corporate and securities partner in the Palo Alto office of Wilson Sonsini. He represents technology and inner league growth companies in financing, strategic transactions, public offerings and mergers and acquisitions. He's active in the angel community. He's the Chairman of the Angel Venture Financing Subcommittee of the Committee on Venture Capital and Private Equity of the ABA.

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material facts must be made to investors so that they may have the benefit of the facts in making their investment decisions," citing Affiliated Ute Citizens v. United States, 406 U.S. 128, 151, 92 S. Ct. 1456, 31 L.Ed. 2d 741 (1972), and 1968 U.S. Code Cong. & Adm. News p. 2813).

Next to Yokum is Greg Yadley. Greg is a long-time committed supporter of the forum, and he is a partner and the Chair of the corporate practice in the Tampa, Florida, office of Shumaker, Loop & Kendrick. He represents clients in financing transactions, M&A transactions, contract negotiations and legal compliance in general corporate matters. And Greg is also, thankfully for us, a member of our Advisory Committee.

Next to Greg is Heath Abshure. Heath is the Arkansas Securities Commissioner. In that position, Heath oversees the state agency charged with oversight of all aspects of the securities industry, as well as certain aspects of the mortgage lending and money services industry. In addition, Heath serves as Chairman of the North American Securities Administrators Association (NASAA) in the role as the Head of the Corporate Finance Section Committee. He is also a member of our Advisory Committee as well.

And to my left, joining me from the staff, is Joe Furey. Joe is the Deputy Chief Counsel of the SEC's Division of Trading and Markets. Joe is here to help us work through some issues that are focused on by the Division of Trading and Markets, which Greg will speak on related to finders.

So, before we begin the panel, I'd like to give you a little background of the work the staff is doing in the area of capital formation for private companies. As the Chairman mentioned, she has asked us to take a fresh look at a number of areas relating to private company capital formation. Three of the areas that we'll touch on today relate to new capital-raising strategies and Professor Bradford will talk to us about crowdfunding. Another area is relooking at the restriction on general solicitation in connection with private offerings and Yokum will speak on that. And she's also asked us to look at the triggers for public reporting, and these are the Section 12(g) rules, the 500 shareholder threshold, and looking at assessing what are the characteristics of a public company. What should we be considering as the triggers for public reporting? And Greg will speak on that. I'll now turn it over to Steve. Steve will hopefully give us a little background on what the Advisory Committee's doing and kick off the panel.

Stephen Graham: Okay, well, thank you, Lona. It is good to be here, and I think that Gerry's disclaimer applies to me as well, and notwithstanding the fact that I'm a volunteer, I guess, at the SEC and not an employee. But the fact remains my comments are my own. They are not necessarily the views of the Commission or my committee.

The importance of the small and emerging companies factor into our nation's economic well-being is understood. There are nearly five million businesses in the U.S. that employ less than 20 people. There are nearly 5.5 million businesses in the U.S. that employ less than 100 people. Going back and looking at who's out there generating jobs these days, in 2010, companies with venture roots employed 11 percent of the total private sector employees and that same group generated revenues that amounted to 21 percent of our GDP. And I could go on. I mean, clearly this is a sector that is the driver of our jobs and innovation. And as we all know, these entities are often transformed over the years from an idea gaining expression in a garage to the H&P's, the Cisco's, the Apple's, the Starbucks'.

And critical to the health of this sector, of course, is capital formation and, as you know, the mission of the Commission is facilitating capital formation along with protecting investors and maintaining fair and orderly markets. And consistent with this mission and increased focus on challenges faced by small companies seeking access to capital, the SEC Advisory Committee on Small and Emerging Businesses was formed last month after a gestation period of nearly a year. It's a good group. It's representative of a broad cross-section of the small and emerging company ecosystem. It's a group that has proved itself to be thoughtful and engaged and necessary for bringing a real-world perspective to this process. We will be advising and making recommendations to the Commission from time to time during our tenure, providing directional advice and encouraging change to facilitate access and ease the regulatory burden. We will not be putting together just one report. Instead, we expect to provide a series of recommendations and hopefully beginning before year-end.

The committee will focus on capital raising by these companies, as well as trading in the securities of such companies and public reporting and governance issues. And, as was indicated earlier, we had our first meeting a couple of weeks ago, and I think we're off to a good start. I expect good ideas to emerge and expect to be able to helpfully effect a meaningful change. Initial areas of focus affecting private company capital formation include general solicitation, Section 12(g) and crowdfunding, among others, and these areas, as Lona indicated, will be addressed by our panelists, but I want to start with a few comments.

First of all, as far as general solicitation is concerned, we all know that that's kind of the cornerstone, certainly one of the cornerstones of our private placement exemption framework, primarily dealing with Section 4(2) and in Regulation D. Essentially, no advertising and there's got to be a pre-existing relationship. And, you know, the fact that this is not permitted, you know, cuts down severely on the pool of potential investors. And I wonder, is it really necessary in the context of Rule 506? The focus already is and should be on the nature of actual investors. And so perhaps an exemption could be modified or provided so that if you're dealing with a situation where 506 would otherwise apply and everyone is accredited, then why would it matter where the purchasers came from? And certainly that would be a boost to 506 and that would significantly expand access to capital to entrepreneurs relying on that rule.

And this dovetails, at least to some extent, to the issue of crowdfunding, which is something that a number—a lot of people are addressing, addressing here, addressing on the Hill. It certainly is being addressed by our committee as well. If you're offering to a crowd, then general solicitation would be implicated. And, of course we're talking about access to startups and to access the capital on the part of start-ups and very small companies and there are thousands of honest innovative entrepreneurs out there who simply do not have access and crowdfunding could be the answer to giving life to their ideas.

As everyone knows, and I think, you know, the panelists will get into, the primary levers in coming up with an exemption in this area, you know, has to do with what limits do you place in the total size of the offering and what limits do you place on the size of the individual investments? And if such an investment could be crafted, then thousands of entrepreneurs across the country may suddenly find themselves with access and feasibility to launch their ideas. Crowdfunding could also give life to the ideas of fraudsters. I don't think that the SEC's job is

to protect people from themselves, the SEC has to be careful not to facilitate dishonest markets. And any exemption would have to be structured properly to address investor protection, but there are challenges to striking the right balance, but I'm confident that this challenge can be overcome eventually leading us to another way to give access to the small entrepreneur who, again, otherwise would have very limited access to capital or no access at all.

This also dovetails with Section 12(g) and the 500 shareholder rule. Expanded access means you're increasing the likelihood that privately-held businesses will bump up against the 500 number and, as you know, once you have 500 shareholders of record, then you're looking at becoming subject to the 34 Act reporting requirements. This is one area that requires serious examination, and change is required, but the question is, you know, what is the right number? Does it depend on the nature of the business? Would some sort of interim bump up to say 1,000 be helpful? How do you count? The whole notion of having record holders, I think we all understand, is a little bit outdated. It leads you to the anomaly where you can have a public company that is able to go dark while a comparable privately-held company who doesn't have a bunch of shareholders—well, for the most part all the beneficial holders are also the record holders and would have to begin reporting. Or maybe the concept is artificial and needs to be banded all together and maybe there's—there should be a new test to determine whether or not a company is public for these purposes.

And one last thing that I just wanted to note is to take a minute on the demise of Regulation D, which is to me further evidence of the need to kind of overhaul the existing system that we have for private placement exemptions. The regimen that we have of 504, 505 and 506 is a sensible and balanced approach to the area. And it was a good idea, continues to be a good idea, but is just—I just wonder how effective it is these days. Because of the state regulation overlay, 505 and 504 are much less useful than they should be and, in fact, almost nobody bothers with 504 or 505, because of the more burdensome information requirements that are entailed on the need to comply with blue sky. And so, again, nearly everybody uses 506, even for small offerings of less than a million dollars. And then as far as 506 itself is concerned, its utility is being affected as more and more people—more and more companies who go out and get their financings are in stealth mode and they don't want the public to know that they've raised money and so instead of doing a 506 and filing a Form D, they just go into, again, stay in stealth mode and rely on Section 4(2) instead. And so, perhaps it's time that the state law preemption extend to 504 and 505 and perhaps, you know, a quiet Form D filing, should be allowed in the context of a 506.

And so with that I wanted to turn the mic over to Professor Bradford who will take us through crowdfunding, which again, I think is a sound idea conceptually, but clearly the devil's going to be in the details. Professor?

Steven Bradford: Thank you. Good morning. As someone said, I've written an article on crowdfunding and federal securities laws and I'm only going to be able to hit the highlights today. If you're interested in reading the full paper, it's available, among other places, on the SSRN website. The URL is on the slide or if you want to give me your card during one of the breaks I can email it to you.

I don't know how many of you are familiar with the basic idea of crowdfunding, so let me just begin with a basic description. In essence, crowdfunding is the use of the Internet to raise money through small contributions from a very large number of people, the crowd, if you will. Someone with a business idea posts an appeal for funds on a publicly-accessible website and that appeal is communicated to the general public through the site and people who want to contribute can contribute anything from a few dollars to the entire amount that the person needs. Crowdfunding, in essence, is a very efficient way of combining very small combinations to—for businesses to get capital. There are a number of websites out there that facilitate crowdfunding. You've probably heard of some of the major ones, like KIVA and Kickstarter. In essence, those sites act as intermediaries to bring together people who need money and people who are willing to give. Now, it's not essential that an issuer use an intermediary to raise funds through crowdfunding, but the best way to reach the crowd, obviously, is to use a site that people know does this on a regular basis and I'll talk a little bit later about why I think an intermediary ought to be required.

Crowdfunding isn't limited to businesses of for-profit ventures. In fact, it's used a lot for a lot of non-business fundraising, but obviously the important issue for our purpose is the use of crowdfunding by a business to raise capital. I think that crowdfunding has the potential at least to do for small business capital formation what Google did for research. Before Google, people did research in libraries and reference books. After Google, it's important to note, libraries and reference books didn't disappear, but Google displaced them for one type of research, very quick, cheap, on the fly research. Similarly, I don't think crowdfunding is likely to kill venture capital or public offerings, but it does have the potential to become the fundraising choice for very small businesses that either don't have access to or can't afford other forms of fundraising. There is what some people have called a small business capital gap. Very small startup businesses find it difficult to raise capital and crowdfunding would help fill that gap. The capital gap is partly geographical. Small business investors tend to focus on local investments. So, if you're located far away from the major sources of capital, funding is a lot more difficult and obviously funding through the Internet doesn't have that geographical limitation, but the more important problem relates to size.

The usual sources of start-up capital, venture capitalists, angel investors, bank lending, often aren't available for very small offerings, say a million or less and especially below about half a million. Those small offerings just don't scale very well for venture capital firms or most angel investors and banks are reluctant to lend to startups with very little operating history. So, crowdfunding opens up more sources of capital by bringing together entrepreneurs who wouldn't ordinarily get financing with investors who wouldn't traditionally be investing in startup financing. Crowdfunding is already being used by businesses to raise money, but in ways that don't involve the sale of securities; through donations, through pre-purchases of products, other kinds of things that very clearly aren't securities. If crowdfunding is going to have a major impact, though, on small business capital formation, it's going to have to involve some sort of financial return that would make the investment a security, whether it's interest or participation in profits. And that's going to work only if federal securities law is adjusted to allow it to work.

There are two major securities law obstacles to crowdfunding securities offerings. The first and most obvious obstacle is the registration requirement in the securities act. Registration is simply

too expensive for the very small offerings that crowdfunding attracts. Cost of registration would often be greater than the total amount of the offering. So, if crowdfunding is going to work for securities offerings, there has to be an exemption from the registration requirement. The problem is that none of the existing exemptions fits crowdfunding very well. I go into a lot of detail in my paper and I won't repeat that here, but basically all of the existing exemptions are either too costly in terms of the requirements they impose for those very small offerings, or they impose restrictions, like general solicitation, that simply wouldn't allow crowdfunding. So, crowdfunding isn't going to work under federal securities laws without a new registration exemption.

The second major obstacle to crowdfunded securities offerings is a little less obvious and it's one that not as many people have focused on. As I said earlier, crowdfunding sites basically act as intermediaries to bring together issuers and investors. If those entrepreneurs are offering securities, there's a serious risk that crowdfunding websites would be treated as brokers or even possibly investment advisors. If you've worked with the definition of broker and I assume at least some of the people in the audience have, you know that there's a lot of uncertainty, to put it mildly. The SEC takes a very expansive view of what constitutes a broker and crowdfunding sites deviate in fairly important ways from what the SEC staff and the no action letter has allowed in other contexts. There aren't any cases or no action letters yet dealing with crowdfunding, but there's a serious possibility given what's out there that crowdfunding sites would be treated as brokers.

I argue in my paper that there ought to be exemption for crowdfunding so crowdfunding securities offerings would not have to register under the securities act and also so that crowdfunding sites that meet certain conditions would not be treated as brokers or investment advisors for purposes of registration as either one of those. Now, when I started working on this paper a little over a year ago, a crowdfunding exemption really wasn't on many people's radar screens. In the last six months the idea has just exploded onto the public policy scene. The White House in very general terms has endorsed the crowdfunding exemption. The SEC staff is looking at crowdfunding. H.R. 2930, a bill to establish a crowdfunding exemption, passed the House just two weeks ago with the president's endorsement and another crowdfunding bill, Senate 1791, has recently been introduced in the Senate. So it's looking increasingly likely that there will be some sort of crowdfunding exemption, something I wouldn't have believed if you'd told me that a year ago.

The question really is what should it look like? And I think there are a couple of things we need to keep in mind in crafting an exemption. First of all, investing in small businesses, especially at the startup stage, is extremely risky. There is a disproportionate risk of fraud. There is a major risk of self-dealing by the entrepreneur and, more generally, small businesses tend to fail at a disproportionate rate and that's basically capitalism. You throw out a lot of different ideas and only a few of them survive. That risk becomes particularly problematic when you factor in who's investing in crowdfunding. Remember this is the crowd, the general public, not sophisticated or accredited investors. And the research shows that the general public, at least on average, is rather remarkably unsophisticated financially. So, if we allow crowdfunding, we're going to be letting relatively unsophisticated investors put their money into what are relatively risky investments. Some people have focused on that combination of risk and lack of

sophistication and argued that a crowdfunding exemption would result in more securities fraud. I think that's absolutely correct. There will be more fraud if we allow crowdfunding, but that by itself is a trivial point, not fraud, but just that point. If you allow more securities offerings of any kind, whether those offerings are registered, private or crowdfunding, there is going to be more securities fraud. If our goal was just to prevent fraud we would simply outlaw all securities offerings. We don't, because those offerings obviously have benefits in addition to their risks. So the real question is whether the capital formation benefits of crowdfunding outweigh the costs, including fraud, and I think they do.

For what it's worth, a lot of money is now going into non-securities crowdfunding and fraud, at least so far, has not been a major issue, even though from the fraudster's standpoint the financial incentives are the same, whether or not securities are involved. In any event, I think it should come as no surprise to this group that there's a tradeoff between small business capital formation and protecting investors. So the question is, how do you structure a crowdfunding exemption to deal with that tradeoff? If you look at the proposals, there's general agreement on two basic features of any exemption. First, you limit the offering amount. The problem is at the small offering level, so we need an exemption for those small offerings. I propose a cap of $500,000. The House bill has a cap of one to two million, depending on whether the issuer furnishes audited financial statements. The Senate bill has a one million limit. There's no magic number. It's just a question of where you think the need is for capital formation, how large offerings are that can't succeed elsewhere. The second point on which everyone seems to agree is a limit on the amount that each investor may invest. The idea behind that is to limit investors to an amount that they can afford to lose. Since there's a significant risk of loss in business investments, let's make sure the individual can afford it. There's a lot of disagreement about what that level ought to be. I propose the greater of $500 or two percent of the investor's annual income. The Senate bill is just a flat $1000 limit. The House bill proposes that the limit be the lesser of $10,000 of 10 percent of annual income. Personally, I think in terms of the House bill, if what we're focusing on is how much investors can afford to lose, that might be a little high for the average investor. But most crowdfunding supporters agree on those two basic types of limitations, although they might not agree on the exact numbers.

But beyond that, what kind of requirement should a crowdfunding exemption include? I go into a lot of detail in my article, but what I want to do in the time I have left today, instead of focusing on all those details, is to talk about some general themes that I think a crowdfunding exemption should follow. First of all, as little regulation as possible. We're talking here about relatively small offerings. Some crowdfunding offerings are even in the $25,000 to $50,000 range and all of them obviously are going to be below whatever the exemption maximum is, one million or whatever. At those levels it won't take much regulatory costs to eliminate crowdfunding as an option. So if a crowdfunding exemption is going to be worthwhile, it needs to be relatively unencumbered with regulatory requirements. Second, minimal filing or mandatory disclosure requirements. This kind of goes hand in hand with what I just said. Filing and disclosure requirements almost invariably require lawyers, and the expense of sophisticated securities counsel adds up very quickly. So the key, I think, is to address the risk of fraud and other losses through other means. And along those lines, keep in mind again that the exemption is structured to limit investors to an amount that each of them can afford to lose. That's going to prevent any catastrophic losses. In addition, the antifraud rules would still apply. Nobody's

proposing to exempt anybody from those that I know of. That's the best way, I think, to go after fraud, because it only imposes costs on those engaged in fraud. With mandatory disclosure, we're imposing costs on small businesses in general in order to prevent wrongdoing by a few who engage in fraud.

And then finally, there are other ways to help protect investors that don't impose as huge a cost on issuers. For example, requiring that the offering be on the website of a neutral intermediary which isn't participating in the offering, requiring that crowdfunding sites be public and that investors be able to communicate with each other on those sites, not allowing offerings to close until the issuer meets a funding target, so at least we know that the issuer has convinced a number of people that its proposal is worthwhile. With requirements like that we can get some investor protection, but at a much lower cost, I think. To the extent that a crowdfunding exemption does impose regulatory requirements, I think those requirements should be imposed on the crowdfunding sites, not on the issuers. The small companies and entrepreneurs most likely to engage in crowdfunding are poorly capitalized and legally unsophisticated. They don't have—they can't afford sophisticated securities counsel to guide them through a labyrinth of complex regulation. Too much complexity at the entrepreneurial level will destroy the exemptions utility and produce a host of unintentional violations. Crowdfunding sites, on the other hand, are going to be repeat players. They can spread any regulatory costs over a large number of offerings. They'll be more heavily capitalized than the entrepreneurs using the sites and they can afford securities counsel. Crowdfunding sites are also much more visible to the SEC for enforcement purposes. So any conditions needed to protect investors should be imposed at the site level. In essence, you should use crowdfunding intermediaries as gatekeepers. That doesn't mean you can't have restrictions on offerings and on the people doing the offerings, it just means you leave it to the crowdfunding sites. You require them to enforce those restrictions. That's the problem I have with the House bill. It basically allows offerings directly by issuers without any intermediary and you don't have that gatekeeper. And I don't think that's a particularly good idea.

Finally, I know we have some state regulators in the office—in the audience and this is not going to make them happy, but I think that any federal exemption should preempt both state offering registration requirements and state broker registration requirements. I think state regulators have an extremely important role to play here in antifraud enforcement. My problem with the state registration requirements is cost. The cost of registration at either the federal or the state level is basically going to kill most of these small offerings. And the only way to guarantee a uniform exemption from those requirements is to mandate it with a preemption provision at the federal level. Well, as I said, my article goes into much greater detail, but that's a general idea of how I think a crowdfunding exemption ought to be structured. Thank you.

[applause]

Stephen Graham: I have one thought, Steve, or maybe a question for you. There's—as you pointed out, the focus is going to be on these dollar limitations, how much you can invest and the size of the offering. And, you know, maybe a thousand, maybe $100,000 is the right number, maybe five million is the right number. Has there been any thought given to having kind of a

crowdfunding exemption that scales, you know, tied to the—you know, back to the nature of the investors?

Steven Bradford: You know, since I've written an article talking about scaled exemptions, I appreciate the plug. I think that would certainly be a possibility, that obviously the larger the offering is, the more you can afford to impose regulatory—the cost of regulatory requirements on that offering without basically killing it. And the smaller it is, the less likely that's the case. I don't know what figures you'd want to use. I mean, clearly if you get up above five million there's been an existing exemption, 505, and I guess Regulation A as well, that would've allowed those kinds of things. But I think yes, I think the smaller you get the less regulation there ought to be, simply because it's not a choice between having some regulated offerings at that level. It's just simply a choice of whether we're going to allow those offerings to proceed or not and if you put a lot of costs on them, they're simply not going to be those—they're not going to proceed at all.

Heath Abshure: Professor Bradford, of course, as I'm sure you anticipated, the state regulator does have a comment on preemption. And your statement that the only way to guarantee uniform treatment is through preemption, the only arguments I typically hear when I'm on the Hill supporting preemptions are arguments of cost and convenience. And I think that in crowdfunding we, the states, are perhaps the most appropriate regulator in this area for one of a number of reasons that I'll get to in a second, but I don't want you to jump to the conclusion that the states can't provide a cost-effective convenient uniform way of addressing crowdfunding offerings, because I think we can. I think we haven't had the opportunity to show everyone that we can, but we can.

But I do think the states are going to be the best regulator here, because we have the greatest interest in seeing small local businesses succeed. We're in the best position to understand the local and regional economic challenges faced by both the issuer and the investor and I think we're more likely to be used as—utilized as a real resource of both the issuer and investor. And if the argument, the only argument, supporting preemption is one of cost and convenience and having a uniform system, I think my plea would be let us show you we can develop that system.

But I would also like to ask Mr. Yadley and perhaps Mr. Graham to recall the conversation we had at the Advisory Committee meeting and some concerns that were expressed there, that the SEC and having the preemption at a federal level, we're getting the SEC into something that maybe we're concerned about the SEC being the primary or sole regulator in.

Stephen Graham: Well, Greg, feel free to chime in. Certainly there were a number of people on the committee who expressed concern about exposing the SEC to a set of facts and circumstances that would adversely affect "the SEC's brand," if you will. I think that, you know, that concern is certainly warranted, but I think that that just, from my own personal view, is that that just takes you back to, you know, focusing hard on how such an exemption might be structured. I don't think it's necessarily, you know—should lead one to the conclusion that this is something that the SEC itself should stay out of. I mean, if the states are in a position to properly regulate, you know, this area, if the states can find a way to come up with exemptions that work, it would seem to me that the SEC could come up with an exemption as well.

Heath Abshure: And the one other thing that Professor Bradford mentioned that caused me a little concern was the idea of as little regulation as possible, and I think the focus needs to be on reasonable regulation. If the idea is to stay completely out of the area, I don't think you're ever going to foster that sense of trust in the market that's essential for economic growth to develop, echoing Commissioner Aguilar's comments from this morning. So I think that there has to be some regulatory presence there and that regulatory presence has to balance the needs of the investors and the needs of the issuer in a way that facilitates the actual reasonable use of its new market, and I think that's a focus that the states have, as do the people on the Hill. But I do think that the states do very much have a role they want to play in this area and that they can provide a uniform—a method of dealing with this, and once the particular substance of the exemption itself is kind of worked out, if it's uniform throughout the entire—throughout the states, in a very cost-effective and convenient manner, I think we're the more appropriate regulator here.

Steven Bradford: If I could just respond. First of all, I have no problem with reasonable regulation and I think we might disagree about what reasonable is in this context, but second on the preemption question, if I'm hearing you, your comment is basically wait for us and we'll develop a cost-effective structured regulation. I would say why not put it the other way around? Let's go ahead and preempt and if you can come forward with a cost-effective structure for regulating these things, then we'll end the preemption.

Heath Abshure: You would be amazed at how hard it is to get authority back once it's taken away from you, Professor.

[laughter]

Lona Nallengara: Professor Bradford, a question for you. Your article and your remarks indicate that you thought the best way for regulation would be through the regulation, or rather oversight, of the intermediaries. And both the House and the Senate bill offer a framework for that oversight. What are your thoughts? I know it doesn't entirely line up to your proposal in your article, but what are your thoughts on the scope of that oversight provided in the two bills?

Steven Bradford: Actually, I think that a lot of things in the two bills do add up to what was proposed in my article and I have a feeling some of them were stolen. Stolen is not the right word, but some of them were taken directly out of that article.

I—for the most part, I like the ideas. I said I don't like the fact that in the House bill you can do it without any intermediary, because I think that ought to be a requirement. I think that's very important. But for the most part, many of the things that they've done are things I've proposed. There's a couple of things that are ambiguous that I'd like to have a little bit better idea as to what exactly they mean in those bills. There's something in there requiring intermediaries to take I think it's "reasonable fraud protection measures" or something like that. I think both I and the intermediary who is like—the intermediary has some idea of exactly what that is. But I think, you know, without endorsing either bill, I think they're both headed in the right direction at least.

Stephen Graham: And just one more thought. You know, going back to general solicitation, if we're able to lift that and so therefore you could do a 504 with general solicitation of 505 and of 506, would there be any need for crowdfunding?

Steven Bradford: Well, you still have the preemption idea if you're talking about 504.

Stephen Graham: Oh, absolutely, right.

Steven Bradford: With 506, you're back to accredited sophisticated investors and, as I said, if you're doing crowdfunding we're really not—the idea is to go to investors that these very small offerings wouldn't otherwise get and I think most accredited investors are unlikely to invest at the small levels we're talking about, which is part of the capital gap issue in the first place. I mean, these companies could do 506 offerings now, just not through the Internet or perhaps through the Internet, just not quite as easily as it's done now.

Stephen Graham: That might change if you could use the Internet.

Steven Bradford: Yeah.

Stephen Graham: Then you could just basically offer it to the world.

Steven Bradford: Well, you could offer it to the world, but you'd still be limited to accredited sophisticated investors and if they're not willing to invest at the very small levels, then that's not really going to help.

Stephen Graham: That's right. You could offer it to every accredited investor in the world.

Steven Bradford: Yeah.

Stephen Graham: Which is a big number.

Steven Bradford: Yeah. But again, you still have the problem of scale, whether those people are willing to make those kinds of investments.

Stephen Graham: Right.

Lona Nallengara: Let's turn to Yokum.

Yokum Taku: Thank you. So my contribution to this conversation is probably from a practitioner who's in the trenches. I live and work in Palo Alto, California. Facebook is two blocks away from my house. I see Mark Zuckerberg walking by my house basically every day. I go to coffee shops in Menlo Park, Palo Alto, Mountain View and the South Market area of San Francisco, and I see angel investors meeting with start-up companies. I represent start-up companies in the Web 2.0 area, mobile software. Everyone is trying to become the next—now they're household names, Facebook, Twitter, Zynga.

I've probably completed somewhere in the neighborhood of about a hundred private company financings in the last year or so. So, my perspective on this from my clients' perspective is one, we need to get these financings done very, very quickly. The second thing is we don't have time to kind of look at a lot of things. You know, people don't want to spend an extra $1,000 to comply with you know, this, that or the other thing. Legal fees are very, very important for startup companies. The typical financing that I work on involves a two-person startup company. Maybe they're raising somewhere between $500,000 to $1.5 million, very early stage companies, there is as a practical matter, very little disclosure done. They raise money on three to ten PowerPoint slides. You've got to be kidding if you think that these companies are going to put together anything that looks like a Reg D compliant private placement memo, anyone that tells me or asks me questions like that, you know it's like kind of talking to a Martian. These things just as a practical matter in the trenches do not occur.

So, there are certain fact patterns that I thought might be interesting, you know that the panel might want to hear about and the general audience. You know, one is the rise in angel investor pitch sessions and demo days. So, one of the things that's happened probably over the last couple of years is the rise of incubators. Generally, incubators in Silicon Valley give startup company entrepreneurs somewhere in the neighborhood of 20K for a three-month program, enough to live off ramen or pasta and Prego, for maybe six percent of the company. These incubators include things like Y Combinator, Text Stars, Angel Pad, 500 Startups. At the end of the three-month program, most of these incubators end up having what's called a demo day. In a typical demo day, if you're Y Combinator, I think 63 companies pitched. Everyone gets about six minutes to pitch and the audience is probably about an auditorium size or whatever, you know whatever number of people can fit into an auditorium. So, maybe these pitch sessions range anywhere from I would say 100 people to 500 people on the large end.

In some of these pitch sessions, let's say you're pitching at Tech Crunch Disrupt. So, Tech Crunch is a blog that follows the tech industry and startup companies compete to pitch on-stage at Tech Crunch. Some of these pitches are live-streamed on the Internet. There's generally no restrictions on who gets to see these pitches, but basically they're up there to kind of publicize their company and of course try to raise money. You know, query as to whether that is a general solicitation? I guess I don't want to know the answer to that. Generally speaking, there's probably, you know, not a preexisting business relationship with the people that are hearing the pitch. There's generally not a test whether people in the audience are accredited or not, you know.

Second fact pattern: the use of the internet in matching investors and startup companies. So, there are now kind of more established, kind of internet platforms, namely things called Angel List, in which companies put up profiles of themselves, indicate kind of who their advisors are, background about the company, kind of terms in which they'd be willing to accept investments, and it is limited to accredited investors. So, hopefully that fact pattern makes people you know, feel better, but basically over the internet, through these web platforms, startup companies meet investors. This is kind of the norm for any technology company these days. If you do not have a profile on Angel List, you probably are either such a hot company that you don't need you know, to do this, or you're not kind of one of a cool kid hot startup companies. Usually platforms like this limit things, limit the investors solicited to accredited investors. You know, once again, you

know query, is that a general solicitation? There's no preexisting relationship with—between the startup company and the people that are being solicited, although I think certainly in that fact pattern, there's a better line of no action letters that make me feel comfortable, but generally speaking kind of the point of these two fact patterns is to ask the question like who really cares if you solicit a bunch of people and you know, you don't buy the securities, does anyone really care? Is anyone really harmed? So, you know, I think that several commentators have suggested that, well, if no one's hurt by these solicitations, why do we really care about it? And the backdrop of having you know, rescission rights because a company has done probably a general solicitation but ended up with three name-brand angel investors that are clearly all accredited. You know, does it really make sense that those three name-brand angel investors have the right to ask for their money back just because, you know, the company solicited, you know, a thousand people over the Internet? Not sure that that really makes sense to me.

Similarly speaking, other fact patterns that show up related to general solicitation are, you know, things like the Facebook/Goldman Sachs offering that was talked about quite a bit earlier this year. Now, I know that the Commission, you know, did not provide guidance and I think it's simply Facebook and Goldman Sachs' internal counsel that concluded that you know, making and offering to all of these people in the United States, you know, was probably inconsistent with a private placement, but it's also troubling to me that, you know, companies that are trying to raise money, you know, have to go talk to their attorneys. Their attorneys spend a lot of time thinking about esoteric things like securities laws that our clients really don't kind of want to be bothered with, and at the end of the day, you know, if they end up selling securities to, you know, accredited investors who are able to fend for their own, you know, ways, like why are these things, you know, things that I as a practitioner in the trenches, why do I need to kind of think about this every day?

The second trend that I want to comment on is kind of technical compliance with securities laws. So, one of the things for my clients and also for the investors that I represent is as a practical matter, a lot of these companies that are talked about in Tech Crunch want to be stealth. If you're kind of the founder of a hot technology company, you really don't want to let the world know that you've been financed and as a practical matter, we've been seeing an increasing trend to investors and startup companies, simply not wanting to file Form Ds as a result of that. You know, query as to, you know, what happens, we do not file a Form D. You know, I think that state security regulators would tell me that, "Okay, if you're relying upon Section 4(2), because you don't have a good Reg. D offering, well, then you need to go figure out what to do in each and every state that you're offering securities in, and once again, in the trenches where I am doing, you know, venture financings where the companies are raising 500k and they incidentally have an investor in fill in name of blank, of state that Yokum does not know off the top of his head whether there's a private placement exemption available or what the disclosure requirements in that state are. You know, there's a lot of extra efforts and time, and complexity that goes into these financings, that probably isn't warranted, kind of given the nature of who's investing, their ability to fend for themselves, and just kind of the nature, you know, of these transactions.

You know, a separate kind of sub-point from, you know, not filing Form Ds is you know, compliance with state securities laws and I'm sure that Heath probably, you know, will not, you

know, like my comments in this area. But you know for me, if I end up doing a venture financing and let's say I don't end up filing a Form D, and I've got investors in, you know, 12 states. That's a lot of attorney and paralegal time to go figure out compliance in those states, and it's really, you know, in the context of the transactions involved, it just doesn't make sense to spend another you know, $1,000 per state to go figure out you know, what we need to get done. I mean our clients are expecting me to get convertible debt financings done for like five to 10k, and it just doesn't make sense in the context of that.

Final kind of general observation on trends that we're seeing in Silicon Valley are the rise of secondary markets. So, now there are secondary markets like SecondMarket and SharesPost, that allow holders of securities of private non-listed companies to sell them to other people. There's clearly demand for hot private companies, the Facebook, the Twitters, and the Zyngas of the world. So, one fact pattern that kind of comes up often times, that kind of troubles me is you have an early employee of one of these hot startup companies. They've received an option. The person wants to exercise their option and then immediately sell the stock to a third party, whether it's, you know, on a platform or not on a platform. You know, doing the securities law analysis for this, Rule 144 isn't available to these folks because he hasn't held the securities long enough. He hasn't held them for a year. Then we need to go into some complicated analysis as to whether these transactions comply, you know, with 4(1 ½), and you know, the point of my observation is to say that it certainly would be helpful if there were better bright line rules with respect to resales, to make it, you know, easier for people to sell securities. Once again, it would be interesting for most people to know that, you know, in these resale transactions, there is very little information as a practical matter that goes back and forth. In a recent transaction that I worked on, on one of these high profile companies, I would, you know, representing the buyer, the buyer really doesn't even know the fully diluted share number of the seller, that the buyer—I'm sorry, of the company that he's purchasing securities in—the buyer just doesn't have very much information about the company, all the buyer knows is that oh, well jeez, other people bought stock at this price, so I'm going to buy it too, because I think this company is going to go public in the future. So, you know, you'd be amazed about, you know, the lack of information that goes back and forth as a practical matter in some of these transactions.

There are also other issues with respect to secondary markets that are of concern, but I'm not going to focus on them right now, such as the 500 shareholder rule, et cetera. But anyway, my point is you know, being in the trenches, there's a lot of things that everyone talks about at kind of a very conceptual level, but it ends up interfering with my ability to get my transactions done.

Heath Abshure: I would like to respond. Just one thing I noticed, I assume that the clients that you have, that are supporting general solicitation aren't the same clients that want to not file Form Ds and remain stealthy, that those are two totally different groups and we kind of cheated, because Yokum and I had talked about this before our panel. In terms of filing the Form D or relying on a naked 4(2), at a federal level, and then going out and finding a state law exemption in each state, once you're selling. I think the bigger issue for Yokum and his clients is not necessarily satisfying the state regulator but your civil liability statute. As most of you in this room know, most states had a civil liability statute that usually reads "if you sell unregistered, nonexempt securities, the purchaser's entitled to basically rescission plus six percent," and also has a list of statutory sellers that it would expand liability in those cases, outside of just the

issuing entity. So, as Yokum and I were talking about, I think the bigger issue to consider when weighing, you know, just a 4(2) exemption at the federal level, what do you don't want to do at the states? It's not necessarily that the regulator to be concerned with, but what you're exposing yourself to from the civil liability standpoint.

Lona Nallengara: Yokum, as part of the consideration of the restrictions on general solicitation, one of the questions that we've been asked and that we ask is what are the tests or precautions put on assessing whether an investor is an accredited investor? What's—and when you—if you consider relaxation of who you can solicit, do you think your market would have the appetite for more stricter requirements to ensure that the investors are accredited investors? And maybe you can talk about what's done now on Angel List or one of the other venues that you mentioned. Is it simply a click the box, to identify whether you meet the requirements or not.

Yokum Taku: Sure. So, as a practical matter, if you're on one of the internet platforms, they ask you a series of questions to kind of figure out whether you're an accredited investor or not. You click, you know, various things and you say, you know, "I agree," et cetera. You know, once again as a practical matter, the paradigm that I would look at, kind of general solicitation from is that, you know, I don't really care who's being solicited. I think I care about who actually purchases the securities and I think that, you know, that is the way that I personally would look at it. I don't know if other people would agree with me.

Lona Nallengara: No, that is the way I'm asking you to look at it. I guess the question is if you were going to allow a broad solicitation of all investors, only allowing purchases by accredited investors, there has been—there have been proponents for an easing of restriction also, asking for an increase on the scrutiny on who you're actually selling it to, not simply allowing for a check the box. Has that—how would that impact your market, if there was something else required through some other authentication required, or some other support that you had to establish before you could actually sell to someone who clicked the box to say they were accredited investor?

Yokum Taku: I think that that would simply be more unnecessary paperwork that would slow transactions down, increase cost, and increase legal fees, and I think that that would not necessarily be a good thing.

Gerald Laporte: I'm supposed to be the bad cop here, I think. We still need to get Greg in and we told him he'd have 12 to 15 minutes, and I noticed Commissioner Walter has already arrived for her talk at 12:30, so I'm asking the moderators to do their job.

Stephen Graham: Lona, could you ask Greg to speak, please.

[laughter]

Lona Nallengara: Greg, could you speak, please?

Gregory Yadley: I will speak and try and leave the Commissioner plenty of time and try not to offend Heath. We're talking about access to capital and crowd finding's very interesting, and

I'm learning a lot, and I do what Yokum does, but actually I must not, because I'm not in Silicon Valley, and I don't have all of those people there ready to write big checks.

I practice in Florida. I have a middle market kind of practice and one of the things that is a real impediment to small companies looking for seed capital or early stage financing is how do you find the investors, because there is this prohibition on general solicitation. So, you need to have an intermediary, somebody who will understand your company and help you raise capital. These people are sometimes called finders and the SEC has an old no-action letter that's never been retracted, and not much expanded involving Paul Anka, who was a heart throb singer in the early '60s and was offered a contingent payment for providing a list of potential investors to a fledgling professional hockey team, and he was allowed to provide that list and nothing more, but in fact, small companies want a little more. They want people who will help them do some structuring and give them some advice, and participate in negotiations. All these things have the trappings of being a broker, but the real bugaboo is transaction based compensation that really looks like a commission and that's been the Commission's viewpoint and the viewpoint of the states.

To get registered is certainly possible, but it's expensive and it's upfront costs—now that the SEC no longer regulates brokers directly as it did when I was on the staff, you have to become a member of FINRA and that's pretty expensive. So, why not just use a real broker? Well, real broker-dealers just aren't interested in helping companies raise $50,000 or $100,000, or maybe even a million dollars, so you're sort of left with a no man's land and these intermediaries are out there operating in an unlicensed fashion, and probably are brokers. So, this is something that the American Bar Association started looking at quite seriously in 1999 and 2005 the task force on private placement broker-dealers issued a report, which was endorsed by the SEC's Advisory Committee on Smaller Public Companies, in its April 2006 final report that said there ought to be a way to have some limited regulation for these people. At this forum since 2006, this has been a primary recommendation and to give you a flavor of what I'm talking about, these are some of the criteria that would be imposed for this limited exemption from registration or the limited registration.

First, you could only make sales to accredited investors. We've talked about that a lot and Lona's question indicates that that's still an area of focus. Second, only limited amounts, probably 10 million or 20 million dollars, with a limit on how much an individual investor might be able to invest, for example, ten percent of his or her net worth. Third, people that have committed prior bad acts would be disqualified, so we really want this to be a clean marketplace. Fourth, there should be disclosure of the intermediary's relationship with the issuer and the compensation that it's getting, so that that's all out there, and you should be able to share fees with registered broker-dealers, because that's another problem. Maybe the offering is such that you could get a real broker interested, but then that broker can't share fees with the intermediary. So, these have all been issues that have been bustling around. There's a lot of support out in the marketplace. There's some support within the building and we hope that the focus that this forum is bringing will push this forward.

Now, there's another aspect to this, because of course smaller companies want to grow and they want to succeed, and then ultimately they want to become even bigger and a real way to do that

is to be sold. So, when it's time to recapitalize or be sold, these smaller companies would like intermediaries also and maybe they don't have access to the real brokerage community, so there's a concept called an M&A broker. This is an intermediary who would help a company be sold with structuring and negotiating, and providing advice, helping with due diligence, all these things. It's sort of the ordinary course for the business and as many of you know, generally speaking when companies get sold these days, they're sale of assets. Now, they're obviously lots of exceptions for regulated entities or their tax and other regulatory reasons why you might want to sell the stock of the company, but if you do that, you now have a securities transaction. Same sale of the business as if you were selling assets, but now this intermediary is a securities broker. So, that's an issue.

Fortunately again, there's been widespread support for this and there will probably be some legislation soon. There's some meetings tomorrow with council and representatives of some of the major middle market brokers up on the Hill, and the focus there is going to be a sort of a notice exemption or notice registration for the intermediary, so that there's a federal handle here and the SEC would actually act as a national registry of these people, and the reason that makes sense to me is, because we're talking about the sale of securities, well who's actually acquiring the security? And so the focus of this would be that the person who is acquiring the security, the buyer of the business will actually be involved in corporate governance or senior management of the business, and will have full access to financial and accounting, and tax, and all the other information about the business. Or the acquirer is the seller of that business, the person who controlled or ran it, and who will continue to have access to the information, so long as he or she holds the securities. So, these are pretty good concepts. They're regulatory. They're intended to provide disclosure where disclosure is necessary and there's an eye out for fraud.

Another topic I'd just like to focus on briefly, which Steve introduced is, okay, we've raised this money and now maybe you're going to become public. You may actually have to become public even if you're not in the process of raising money, and that was Section 12(g), which was referred to. So, if a company has $10 million in assets and 500 shareholders, then it has to register under the Exchange Act. This was a late edition to the Exchange Act, was added after a tremendous, thoughtful, expansive special study in 1964, because a lot of trading had developed in the over-the-counter markets, and that wasn't regulated. So, that was the purpose. Now, 1964 was a long time ago and during that time, the asset test has changed. It actually started out as $1 million and has moved up to $10 million, but the 500 shareholder limit has remained the same throughout. So, the question really is, is 500 shareholders a true reflection of what's a public market? If so, how do you count the 500? Well, the way the 500 is counted, as you probably know, is you look at the books and records of the company. With a small company or private company, that's pretty easy, because the record holders pretty clearly reflect the beneficial holders of those securities. However, in a public company with the changes in the marketplace and decertification—lack—no longer securities certificates being the norm, you have professional holders, intermediaries. So, under the rule you look through DTC, to the record holders, who in many cases are brokers in banks. They each count as one. A venture capital investor would be one. A private equity investor would be one. So, for a small company though, who doesn't usually hold stock through these intermediaries, whose investors don't hold stock through these intermediaries, you can grow to be 500 shareholders without too much difficulty over time. A few private placements, some private transfers, some estate planning, family

transfers, and then do a merger with another company, and all of a sudden you're getting pretty close to 500 shareholders. So, is that really, is that really right?

One area where you can see that this is an issue is with banks and bank holding companies. Eighty percent of the banks in this country are very small, so do they need to be publically traded, because there's a huge cost here and at the low end people have said banks pay between $100,000 and $250,000 a year to be public. Many people would say it could be a million dollars, so we have banks who are regulated, much more so than any ordinary issuer. They are subject to lots of federal and state regulation. They're inspected by the FDIC, or the Fed, or the Comptroller, as well as state regulators, and on a quarterly basis, their financials are posted on the FDIC's website. So, not real time reporting, it's not SEC Regulation S-X reporting, but it is financial information and this is sort of a special situation. That's been recognized and there are now two House bills and a Senate bill that would raise the limit for registration to be required for banks and bank holding companies to 2,000.

There's also a bill that would raise the limit to 1,000 for all kinds of companies. This is H.R. 2167 and there's a companion Senate bill there. The bill for bank holding companies and banks, H.R. 1965, was passed by the House on November 2nd, and just this week Senate Minority Leader, Mitch McConnell, has called for a bipartisan effort to approve this. So, that looks like it's moving, seems to make a lot of sense for banks and bank holding companies. Especially, the Advisory Committee that Steve co-chairs, he's got this front and center on the agenda. The staff is looking at it and I think it makes a lot of sense, because it is very costly to be public and what's the benefit that these companies are getting?

In testimony for this forum last year, the American Bankers Association submitted the results of a survey and they found that for banks and bank holding companies with fewer than 3,000 shareholders, there was almost no liquidity and in fact in the survey, which looked at companies with between 410 and 6,500 shareholders, the average daily trading volume over a three-month period last year was 10,202 shares. The average market cap at these companies was $144 million. For banks with less than—bank holding companies with less than 1,500 shareholders, the average trading volume was 850 shares, and their market cap ranged between $17 and $76 million So, really where's the cost benefit? How many investors are being protected?

Just to close, there is another side of this and you might ask in that bank survey, you said that there were some banks that had 400 shareholders. Well, how come they're still public? Well, it's pretty hard to become unpublic, but you can do it. You can go dark and you can go private if you have fewer than 300 shareholders. If you have less than $10 million in assets, if you have fewer than 500 shareholders, and once you go dark, that sort of stops the music for reporting. Your stock may still be out there quoted on the pink sheets and those investors have complained in testimony and letters to the Commission, saying that, "we're left out there without any information anymore," and maybe that's not fair. Some have suggested that there's a link between the lack of information and fraud, and so there was a proposal that was generated, didn't receive much support, but said, "You ought to count holders, count the beneficial holders, it's easy enough to find out," and I'm probably out time. Thank you.

Lona Nallengara: Thank you, Greg. I think we are for the first panel out of time. Gerry—it looks like we are, given that my boss is walking to the podium, but we will be discussing a lot of these issues this afternoon in the breakout sessions. So, I'm sure you have a lot of questions for the panelists and we can continue the discussion at that time, and I'll turn it over to Meredith.

Meredith Cross: Thank you. Let's have a round of applause for the panel.

[applause]

Introduction of Commissioner

Meredith Cross: Thought that was incredibly helpful. So it's now my pleasure to introduce Commissioner Elisse Walter. I've had the privilege of knowing Commissioner Walter since I first joined the staff of the Commission in 1990, when she was the Deputy Director in Corp Fin. I couldn't be happier to work, to be working with her now. Commissioner Walter rejoined the Commission in 2008. Prior to her appointment to the SEC, Commissioner Walter served as Senior Executive Vice President Regulatory Policy and Programs for FINRA. At FINRA, Commissioner Walter coordinated policy issues and oversaw a number of departments including Investment Company Regulation, Member Education and Training, Investor Education and Emerging Regulatory Issues. She also served on the Board of Directors of the FINRA Investor Education Foundation. Prior to that, Ms. Walter served as the General Counsel of the Commodity Futures Trading Commission and before that, as Deputy Director of the Division of Corporation Finance. Commissioner Walter served on the SEC's staff beginning in 1977, both in Corporation Finance and in the Office of the General Counsel. Before joining the SEC, Ms. Walter was an attorney with a private law firm. Please welcome me—join me—in welcoming Commissioner Walter.

[applause]

Remarks by SEC Commissioner Elisse Walter: Meredith, thank you so much for that kind introduction.

I'm so pleased to have the opportunity this morning to be here with you for the 2011 Government-Business Forum on Small Business Capital Formation. I want to thank everyone in our Division of Corporation Finance, and especially Gerry LaPorte and the rest of our Office of Small Business Policy for organizing today's Forum and playing the leadership role in our small business initiatives.

My thanks too, go to our panelists – those who are here now and those who will follow – for participating in this important public-private dialogue on small business capital formation and especially for your commitment to enhancing the growth and vitality of our nation's small business community.

The information you share with us today ensures that we enhance our understanding of the needs of small businesses and their owners.

I hear, loud and clear, the views that these needs are not being met under our current regulatory structure.

I want you to know that the Commission, with the advice and guidance of our team of specialists in the Division of Corporation Finance, stands ready to write the next chapter in our agency's long-standing efforts to address the concerns of small business.

Your recommendations for facilitating small business capital formation, and in particular, the empirical data I hope you will share with us either today or after the Forum adjourns, will be an important contribution to our ongoing efforts to maintain the vitality of small businesses in the U.S. economy.

As I'm sure you have already heard, and will continue to hear throughout the day, there is no shortage of recommendations today from lawmakers and market participants on possible revisions to the Federal securities laws and rules in order to promote small business capital formation.

I, for one, whole-heartedly agree with the President's recent request that we review our rules in order to eliminate any unnecessary burdens. And, I know Meredith does, as well. I believe that there are many areas where our rules can and should be improved. But, should any proposed revision to our regulations veer toward sacrificing investor protection, I submit that such revision will surely come at a cost that no one in business can afford – the loss of investor confidence.

In the few minutes I have with you this morning, I of course cannot cover all of the potential legislative bills and recommendations for regulatory changes in depth. Instead, what I would like to do is to take us for a little trip down memory lane when many of these same issues were also at the forefront of our minds. Then, I'll share just a few thoughts I've had about the recent initiatives to address issues concerning small business both inside and outside our agency.

Of course, as you're going to hear repeatedly today, my remarks are my own and not those of the other Commissioners, the Commission or the staff.[7] And, as is appropriate, please know that my thoughts on all of these issues before us today are evolving.

As you now know from Meredith's introduction, if you didn't know before, I served as the Deputy Director in Corp Fin from 1986 through 1994. Shortly after I commenced work in the Division, my former boss and dear friend, Linda Quinn, delivered a speech some of you may be familiar with entitled "Redefining Public Offering or Distribution for Today."[8] In her remarks, she described the Division's efforts to re-evaluate the concept of what constitutes a distribution or public offering requiring registration under the Securities Act of 1933.

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[7] The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publications or statements by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission, other Commissioners, or the staff.

[8] Linda C. Quinn, Director Division of Corporation Finance, "Redefining 'Public Offering or Distribution' For Today," Address to Federal Regulation of Securities Committee Annual Fall Meeting (November 22, 1986), available at http://www.sec.gov/news/speech/1986/112286quinn.pdf.

Here are some of the statistics she presented that day. In 1981, about $12 billion of securities were offered by issuers in private placements. Only four years later, in 1985, that number had gone up under Regulation D alone to $55 billion and that increase in private placement activity had resulted in the creation of a large secondary market for restricted securities. In 1983, annual trading volume in this market was estimated at $2 to 4 billion, and the trading volume for 1986 was anticipated to exceed $10 billion. Sound like big numbers?

But, when we got an update on some of today's private placement numbers earlier this month, during the meeting of our Advisory Committee on Small and Emerging Companies, our Chief Economist and Director of our Division of Risk Strategy and Financial Innovation, Craig Lewis, reported that in 2010, $905 billion was offered under Regulation D, with this figure representing the lower bound on the amount actually raised due to the fact that no closing filing is required when a company files a Reg D notice.

With respect to broader capital raising trends, Craig and his team confirmed that there has indeed been a shift from public to private capital raising over the past three years, due both to a decline in public issuances and to an increase in private issuances – with public issuances down by 11% from 2009 to 2010, while private issuances increased by 42% over the same period.

I can only imagine what Linda would be saying if she were still with us today.

I know that many of you, particularly Meredith, share my feelings that it is with a very heavy heart that we go forward in our efforts to once again address issues related to public offerings and distributions without Linda's keen expertise, intellect, and vision. But Meredith herself is more than up to the task.

The underlying message of Linda's visionary efforts is an enduring one, and in the view of this Commissioner, should guide us as we analyze these issues today.

In her 1986 speech and throughout her tenure as the Corp Fin Division Director, Linda challenged us to ask, <u>who</u> are the persons who require the protections of the mandated disclosure of the registration process? And, how can we protect them without undue burdens and costs?

The challenge then, and it remains the challenge today, is for us to strike the right balance. And, I think it's a very important word for us to keep in mind as we move forward on these issues.

That is why I fully support our Chairman's decision to have Meredith and the Division take a careful look at our offering rules in order to develop ideas for the Commission to consider that may reduce regulatory burdens on small business capital formation. And, in doing so, we must remember to take into account marketplace and broader societal developments.

At the same time, however, we should keep in mind that these considerations raise distinct questions about when and whether a company should go public. On the one hand, I am a great believer in the transparency and oversight that a public offering brings to investors. On the other

hand, there are clearly some companies that make the determination to go public prematurely and even some companies that should never go public.

If we can move forward with ideas that are consistent with our investor protection mandate, I believe we can address the needs of the small business community. Of course, I remain very much in listening mode at this stage, but some of my initial reactions to the ideas I've heard are as follows:

Review of Certain Offering Regulations

With respect to changes to our offering regulations, any change to the Section 12(g) registration requirements must address, as we were talking about just a moment ago, the fundamental difference that exists between what "held of record" means at a publicly-held company versus the counting that is done at a privately-held company.

Our restriction on general solicitation is one that bears looking at. It appears ripe for re-evaluation because of technological changes. What does general solicitation really mean in an era dominated by electronic communications? Is it still a realistic concept?

And, our rules on public offering communication should be very carefully studied to determine whether the liberalizations afforded larger public companies in 2005 should be extended to smaller public companies.

Crowdfunding

On the subject of crowdfunding, I personally think crowdfunding is a good idea, but it must have limits. If it's too big, it will become a haven for fraud and backfire, and I'm very concerned about the notion of a relatively high limit on a person's income during the year, which might allow them to take everything they earned and put it into extremely risky ventures. And, of course, I continue to believe that antifraud jurisdiction must extend to its furthest possible reaches.

Although I have not yet completed my analysis of all of the recent legislative efforts to address capital formation, I'm hopeful that Congress will avoid being too prescriptive with any legislation it may determine to enact. Of course, we all know that the devil is always in the details. So, if Congress determines that a legislative response is appropriate, I would very much like to see Congress instruct the SEC to use its expertise to define those details. I believe the Commission should, as we have in the past, continue to look for places where we can calibrate the risks of reducing regulatory burdens and the potential cost savings.

Although I can't predict for you today how our next chapter in addressing the needs of small business will read when it goes to press, I do believe that the Commission will build upon the platform established by this Forum today in a manner that addresses the needs of the small business community and is consistent with its investor protection mission.

As I've said many times since I returned to the Commission three and a half years ago, my door

and telephone lines are always open. Please don't hesitate to visit or pick up the phone if there are any of these issues that you would like to discuss with me.

Thank you for the opportunity to speak with you this morning.

[applause]

Gerald Laporte: Thank you very much, Commissioner. Meredith did you want to say anything?

Meredith Cross: Well I guess I was going to play traffic cop. We're supposed to take a break now and I'd like to ask that it be very short because we're supposed to start back up at 11:00 and with Commissioner Gallagher giving some remarks. So if we could take a break that doesn't—if you could be back in seven minutes, please. Thank you.

[break]

Meredith Cross: Ready? Can everybody please have a seat.

Gerald Laporte: If people can take their seats, I think we're ready to start the second panel discussion.

Gerald Laporte: If people could take their seats, I think we're ready to start.

Meredith Cross: All right. Do you want to start off, Gerry, or am I ready?

Gerald Laporte: Yes, before we start the second panel discussion, I'd like to recognize the staff of my office, the Office of Small Business Policy, who have done such a terrific job in putting together this program. First of all, there's Tony Barone, whom the Chairman acknowledged this morning. He's done more organizational work on this forum than anyone else. We owe Tony—he was the fellow who was standing right next to me a minute ago—I don't know where he's disappeared to now—we owe Tony a great debt of gratitude for all the excellent work he's done on this program.

Secondly, if these people could stand up and be recognized. Johanna Losert, of our office; I don't know where Johanna is. She may be busy doing—there she is back there. And then Karen Wiedemann is also in our office. She—both Johanna and Karen—have done a great job in supporting this program. And last but not least, Mauri Osheroff. Mauri was here earlier also. She's not actually in the office—there she is. She's coming in with the red jacket. She's actually not in the Office of Small Business Policy, but she oversees the work of our office as Associate Director of the Division of Corporation Finance. And now, I'll once again turn over the microphone to Meredith Cross who will co-moderate the second panel and make the introductions of the Commissioners.

Introduction of Commissioner

Meredith Cross: Thank you, Gerry. So we now have the pleasure of hearing from our newest Commissioner, Commissioner Dan Gallagher, who was sworn in as a Commissioner on November 7. Commissioner Gallagher previously worked at the SEC for four years beginning in January 2006, as a counsel to Commissioner Paul Atkins, and later as a counsel to Chairman Cox. He joined the Division of Trading and Markets as Deputy Director in 2008, and played a key role in the SEC's response to the financial crisis. He served as Co-Acting Director of Trading and Markets from April 2009 to January 2010. After which he left the agency to become a partner in the law firm of Wilmer Hale. Prior to his initial SEC service as a staff member, Commissioner Gallagher was a General Counsel and Senior Vice President of Fiserv Securities, where he was responsible for managing all of the firm's legal and regulatory matters. Commissioner Gallagher began his career in private practice, where we worked together, advising clients on broker-dealer regulatory issues and representing clients in SEC and SRO enforcement proceedings. And I'm delighted to get a chance to work with Commissioner Gallagher on his return to the Commission. Please welcome Commission Gallagher.

[applause]

Remarks by SEC Commissioner Daniel Gallagher: Thank you, Meredith, for your kind introduction. Thanks also to you and to Gerry Laporte and his staff in the Office for Small Business Policy for organizing this forum and assembling such a fantastic panel of folks to talk through the critical issues that face small businesses in trying to raise capital. Most importantly, I want to thank our panelists for giving their time today to lend their insights into these issues.

This is only my eighth day on the job, and I am incredibly excited to take on my new role as a Commissioner of the Securities and Exchange Commission. I am happy to tell Gerry that, in all my time as a Commissioner, this is the best event that I have ever attended.

At the risk of sounding pedantic, I think it is worth noting up front the Commission's mission: to protect investors, ensure fair, orderly and transparent markets and promote capital formation. As the world economy continues to struggle to emerge from the doldrums of the last three years, and as U.S. regulators work to implement the Congressional response to the financial crisis of 2008 embodied in the Dodd-Frank Act, the Commission faces important questions about how to balance the sometimes competing priorities of investor protection and capital formation.

So I cannot think of a more timely opportunity to discuss these issues than at today's forum, which brings together this group of owners, executives, advisers, investors and advocates for small businesses. Small businesses are truly the lifeblood of the American economy, yet they face a number of challenges in raising capital that may not be shared by their larger counterparts.

I know I am not the first person to recognize and I doubt that I am even the first person at this forum today to state that, if the American economy is to become vibrant once again, small business must be the driver that creates the jobs and economic growth that will lead the way.

A few brief statistics back this up. According to sources cited by the Small Business Administration, small firms—generally, firms having fewer than 500 employees:

- Employ about half of all U.S. private sector employees;
- Pay 43% of total U.S. private payroll;
- Have generated 65% of net new U.S. jobs over the past 17 years; and
- Create more than half of the U.S. private gross domestic product.

If small businesses are to fulfill their role as the engines of economic and job growth, however, all regulators—and not least the SEC—must give them sufficient flexibility to raise capital, operate their businesses, innovate, take risks and otherwise take advantage of opportunities as they arise in the economy. This imperative is particularly true in light of the competition for capital and customers from international firms in places like India and China, which face far less restrictive regulations.

It is widely believed that the increased costs of being public as a result of the Sarbanes-Oxley Act and the Dodd-Frank Act have made it less attractive for smaller and growth-stage companies in the United States to be public, resulting in fewer IPOs and more companies considering going private. Some of these costs, like the unanticipated high costs associated with the auditor attestation requirements of Section 404(b) of the Sarbanes-Oxley Act, are so significant and readily traced to a particular regulation that they attract significant attention, which fortunately can provide the impetus for some regulatory relief.

Others, however, are more incremental and less susceptible to easy measurement. Nevertheless, in part because the accumulation of a number of small requirements can ultimately result in meaningful burdens, these requirements can be just as costly to companies and, as a result, can have nearly as significant an effect on the willingness of companies to undertake a public offering. Some good examples of these requirements are the ever-expanding federally-mandated corporate governance requirements—such as director, audit committee and compensation committee independence requirements and mandated say-on-pay votes—as well as required disclosures of information that has little practical usefulness to real investors.

These costs and burdens can be difficult for any public company to bear, but clearly small companies, with their more limited human and financial legal resources, are often disproportionately affected.

For many of the rulemakings required by Dodd-Frank, the Commission may have little discretion. As we continue to implement the requirements of the Dodd-Frank Act, we should be very cognizant of the risks of chasing IPO candidates into private or offshore capital-raising transactions and look for opportunities to minimize burdens of being public, while remaining true to our mission of protecting investors. In addition to existing statutory requirements to consider the costs and benefits of our rules, some of the provisions of Dodd-Frank specifically charge the Commission with considering whether the required rules would have a disproportionate effect on smaller companies, and grant the Commission explicit authority to exempt smaller issuers. Furthermore, the Commission should use its general exemptive authority under the Exchange Act where appropriate.

It would be easy to minimize the consequences of smaller and emerging companies choosing not to undertake public offerings in the United States. Like the "dog that didn't bark," however, the

economic significance of companies systematically deciding to defer IPOs, to forego U.S. IPOs altogether in favor of raising capital in private transactions or in foreign markets, and of venture capitalists seeking "M&A" exits rather than public offering exits from early-stage investments, should not be ignored.

To the extent that regulations tend to push issuers and investors away from U.S. public offerings:

- Ordinary American investors will have fewer opportunities to seek higher returns by investing in growth stage companies;
- Issuers raising capital, and early round investors seeking an exit, will receive less for shares sold in private transactions because private investors are not willing to pay as much for illiquid investments. This lower return on investment, in turn, dissuades entrepreneurs and investors from pursuing these ventures in the first place, depriving our economy of entrepreneurship and innovation; and
- Investors in these private transactions will be deprived of many of the protections afforded by the Commission's robust disclosure and other rules.

Furthermore, just as we should avoid chasing issuers away from the U.S. public markets, we must also be careful not to insert ourselves into private transactions in inappropriate ways that hinder, discourage or penalize private deals. Private transactions can be a particularly important financing tool for smaller and growth-stage businesses that have not yet tapped the public markets. Clearly, private transactions can provide a number of benefits for both issuers and investors—in particular the ability to close a deal quickly and to agree upon whatever terms the parties deem most appropriate under the circumstances.

Nevertheless, there clearly is some role for federal regulation even of private transactions. Most notably, the anti-fraud provisions of the federal securities laws have always applied to securities transactions, whether registered or not.

Indeed, as my predecessor Kathleen Casey noted, the emergence of trading platforms for shares of private companies is largely an outgrowth of the phenomenon of private, growing companies delaying going public for as long as possible, driven in part by the high cost of being public. As Commissioner Casey and others have also noted, however, while these markets provide much sought-after liquidity for private company investors, they also raise a number of questions about whether investors that purchase shares on these markets require the protections afforded by the federal securities laws.

In addition, our regulations set forth detailed criteria for private transactions to be exempt from the registration requirements of the Securities Act. These criteria are intended to limit private transactions to instances where the need for the protections of the federal securities laws and regulations is diminished, such as where investors are sophisticated or have sufficient resources to fend for themselves.

The Dodd-Frank Act restricts or requires the Commission to adopt rules that restrict private placements in some measure. These provisions include the exclusion of "bad actors" from reliance on Rule 506 under Regulation D and the elimination, for purposes of determining

whether a natural person is an “accredited investor,” of the value of a person’s primary residence from the calculation of his or her net worth. The Commission proposed rules relating to these provisions before I started, and I am reviewing these proposals and the public comments on these releases with great interest as I consider what rules I believe we should ultimately adopt.

In addition to carefully considering the impact of any new regulations that we adopt, we should, where appropriate, also consider whether there are existing regulations that are unduly restrictive. I am happy to say that there have been a few bright spots to point to over the last year or so in this regard.

In the Dodd-Frank Act, Congress appropriately, in my view, exempted smaller issuers from compliance with the auditor attestation requirements contained in Section 404(b) of the Sarbanes-Oxley Act. The benefits of the rule to investors simply were not worth the compliance costs.

I am also very pleased that both Congress and the Commission are considering ways to make private capital markets more robust, including consideration of:

- easing the limitation on general solicitations in the private placement exemptions;
- increasing the offering size limitations under Regulation A;
- creating an exemption from registration under the Securities Act for so-called “crowd-funding” transactions; and
- raising the 500-shareholder threshold for registration under the Exchange Act.

Certainly, these proposals raise a number of issues that we must understand and address. Nevertheless, I believe these proposals represent a strong step in the right direction. It is also notable that the Commission is considering a process for conducting retrospective reviews of our existing rules—given my background, I could list several for you off the top of my head. I hope that all of these considerations will result in improvements in securities laws and recommendations for Commission action that will help small businesses to raise capital, consistent with the Commission’s mission to protect investors and facilitate capital formation.

With that, I will relinquish the microphone to Meredith to kick off the next panel discussion about Initial Public Offerings and Securities Regulation Involving Smaller Public Companies. Thanks once again to our panelists today for their contributions to this important event, and I very much look forward to seeing the recommendations that emerge from today’s forum.

[applause]

Meredith Cross: Thank you very much, Commissioner Gallagher. I will note that the other meeting that I've attended with him since he's been back was a roundtable about accounting and so since this is his favorite event so far, I’ll have to tell Kroeker that I beat him.

Daniel Gallagher: I was going to say my favorite event in the auditorium but --

Meredith Cross: Oh, oh.

Daniel Gallagher: But my council laughed me out of that one too.

Meredith Cross: And that was the multipurpose room.

Daniel Gallagher: Yeah, I'm done with that joke, I promise.

Panel Discussion: Initial Public Offerings and Securities Regulation Involving Smaller Public Companies

Meredith Cross: Okay. So with that, we're going to start off this panel. The topic of this panel is initial public offerings and securities regulation involving smaller public companies. The last panel is—if you can see the themes are—the last panel was exempt offerings and ways for smaller companies to raise capital without being public offerings; this one is about public offerings. I'm looking forward to a lively discussion. First, I'm going to introduce the panelists. Steve Graham, my co-moderator, was already introduced to you during the first panel so I won't introduce him again. I'll introduce the other panelists in the order in which they are seated to my right.

David Weild oversees capital markets and institutional acceptance at Grant-Thornton, a major audit tax and advisory firm. David has recently coauthored two studies attempting to identify how changes in stock market structure have influenced capital formation in United States. He's a former Vice Chairman and Executive Committee Member of the NASDAQ stock market where he has line responsibility for the global listing businesses of NASDAQ.

Next, is Kathleen Weiss-Hanley, she's Deputy Director and Deputy Chief Economist of the SEC's Division of Risk Strategy and Financial Innovation. She's written extensively on corporate finance with an emphasis on initial public offerings, price stabilization, short selling disclosure, litigation risk and closed end funds. She received her Ph.D. in finance from the University of Florida. I can tell you, when you talk about IPOs, she lights up. It's very exciting.

Jack Hogoboom is a founding member of the Lowenstein Sandler specialty finance group. Jack specializes in mergers and acquisitions, public and private securities offerings, private equity investments and general corporate and securities law.

Professor John Coffee is Adolf A. Berle Professor of Law at Columbia University Law School and Director of the Center on Corporate Governance. He's the author—or editor of several widely-used books and case books on corporations, securities regulation, takeovers, and business organization and finance. He testifies frequently before Congressional Committees and testified on both the Sarbanes-Oxley Act and the Dodd-Frank Act.

And Greg Wright is CEO of ThinkEquity, LLC, an investment bank focused on the growth sectors of the economy. ThinkEquity provides research, equity financing, M&A advisory, institutional sales and trading, wealth management, asset management services to institutional investors, corporate and private clients, venture capitalists, entrepreneurs and financial sponsors. I think we have a wonderful panel, I'm so pleased you're here and I thank you for coming.

To my left is David Shillman. David is an Associate Director in the Office of Market Supervision of the Division of Trading and Markets, and he's here to respond to trading and markets questions that might arise and thank you very much for taking time to come, David.

As you heard earlier, at the Chairman's request, the staff is taking a fresh look at many of our rules that affect smaller public companies and public offerings develop ideas for the Commission's consideration. I don't want to take up the panel's time, but one project I'd like to mention that the staff is working on is assessing our rules and the regulatory burdens they impose with respect to public offerings. As you know, 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 the largest issuers during the registered offering process. People refer to that as offering reform. Trying to sound modern, I'm referring to the newest effort as offering reform 2.0. I don't know if that's actually modern, but people use that 2.0 phrase a lot, at least when they're from the Valley.

The staff is reviewing the rules relating to communications and public offerings to consider whether any of the liberalizations adopted in 2005 should be adapted for smaller public companies. Another area of note is the legislative activity surrounding Regulation A. I'm sure the panel will address this. There's a legislative proposal 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; $50 million instead of Reg A's existing five million. Separate from the legislation, the ongoing review of the impact of our regulations on small business capital formation will include consideration of whether the Regulation A ceiling could be raised—should be raised. As you know, we have exemptive authority under the '33 Act generally too, so we could use that to raise the ceiling and then including whether raising the ceiling would promote increased reliance on the exemption in manner consistent with investor protection and whether there are other impediments to use of the exemption that should be addressed by the Commission. I'm looking forward to the discussion of these topics and many others, we are committed to carefully considering these ideas and developing thoughtful recommendations for the Commission and your input will be invaluable to the staff.

Now I'm going to turn it over to Steve for his remarks and to kick off the discussion, Steve?

Stephen Graham: Okay, thank you, Meredith. First of all, I want to say again that any views I express are mine, and not my committee's, not the Commission's. As I said earlier, the SEC Advisory Committee on Small and Emerging Businesses was formed to make recommendations to and advise the Commission on capital formation issues relating to small and emerging companies. Certainly, the state of the small IPO and the cost of being public are at the top of mine, many of us are used to an environment—kind of grew up in environment where you would begin working with a company, take them through several venture rounds, then in time you would work with a bank like H and Q or Alex Brown or Montgomery Securities or Robbie Stevens and then take them public and raise $50 million or less—and you know, what happened? The small IPOs all but disappeared and with it a dramatic decline in job creation and support for innovation.

So the IPO market does seem to be broken and the market issues are aggravated by a fear of going public due to the burdensome and costly regulation. We can debate how burdensome and how costly, but the effects are real and you know, it's—you might say what—you would ask what are the root causes to this situation and so often times you hear and I hear with my clients and others, you know, all the time that it's all the fault of SOX, before—if it wasn't for SOX then things wouldn't be so expensive and the world would be a better place. That's not really true, people don't fully appreciate that but certainly the demise of the IPO—of the small IPO market if you want to call it a demise and I would call it a demise was the—well it began before SOX and it really is a cumulative effect of a sequence of regulatory actions that have driven up costs, driven down analyst coverage and pushed the economics to high frequency trading and away from long term investing. So the real question is how do we fix this and bring back the smaller IPO? I think that we've done a good job in terms of reducing the regulatory burden—and don't say that we're done, but notably the small reporting company system that is now in place exempting from a lot of the disclosure requirements public companies with a public vote of less than 75 million dollars.

Perhaps the issue here is that it's—is that $75 million is too low. Certainly our definition in our committee as to what a small public company is anything with a market cap—any company with a market cap of under 250 million dollars—and maybe there's a role for Regulation A. As you know, probably, you know Regulation A is little used, some might say never used. If legislation passes or if other action is taken to bump up the limit from five to 50 then that might increase the utility. It may put us in a position to eliminate or provide for state preemption of—the concept seems to be valid. The—and I don't know if you continue to call it deregulation A but certainly those concepts would seem to have a place in a system where you're trying to figure out how to make it easier for a privately held company to transition into a publicly held company.

Last March, the Department of Treasury convened, the access to capital conference—and the purpose of that conference was to gather insights from capital markets participants and solicit recommendations for how to restore effective access to capital for emerging companies. And at this conference, a small group of professionals representing a—kind of a broad section of the emerging company ecosystem, from CEOs to lawyers to bankers, and they got together to discuss these issues and they ended up forming the IPO task force. They issued their report last month and then it's entitled "Rebuilding the IPO On-Ramp."

I think it's an impressive report. I think it's well thought out and I think that the voice of this task force is an important and helpful part of the dialogue. Their recommendations are essentially for—provide for an on-ramp for newly public companies, effectively scaling regulation so that they can—just to ease the transition, again, from being a private company to becoming a public company. Number two, improve the availability of information, and then we saw the analyst coverage problem and saw the problem relating to the economic model that now applies. Three, lower capital gains rates for those who invest in IPOs and then hold those shares for at least two years. And three, improved education for management and boards of directors so they begin to understand better the importance of thinking it through your syndicate and thinking it through, you know, how your shares are allocated. I think these are good ideas that deserve consideration.

And with that I will stop talking so we can get to our panel and I think we're going to kick it off

with David.

Meredith Cross: I just wanted to chime in quickly. The one point I'm not sure came across real clearly is that the staff has asked the Advisory Committee to let us know what they think about the IPO On-Ramp recommendations. That's one of the many topics that we've—we keep giving them assignments—and so I think that will be very helpful to hear from business leaders how helpful those recommendations would be in practice, so that's one of the topics we've asked for their thoughts about and look forward to receiving those thoughts.

Stephen Graham: Okay, thank you Meredith. David?

David Weild: Thank you Steve. First—there we go. Okay, thank you Steve. First I'd like to start by thanking the Commission, in particular the Division of Corporation Finance and the Office of Small Business Policy for the opportunity to speak today and also my colleagues Ed Kim and Lisa Newport who bore the brunt of putting much of this presentation together.

We have published a number of studies that have been often cited as the basis for some of the current debate on how to bring back capital formation in the United States and in fact they were cited both in the Jeffrey Immelt jobs council report for the White House and the IPO Task Force Report. Today, we bring some additional analysis and we'll demonstrate that one, stock market transaction costs are too low cost to serve the U.S. economy. Firms need to make money supporting stocks in the aftermarket and once you destroy needed economic incentives in the aftermarket you stunt the IPO market. We're going to prove that.

Once you stunt the IPO market, you set the entire stock market into systematic decline. And finally, the systematic decline, if addressed by springing—spreading commission economics back into the market—we'll bring back economic growth, budget surpluses, millions of jobs and the reinvigoration of the American dream. U.S. stock markets, once known for their ability to birth the semiconductor, personal computer and biotechnology industries, will once again be the envy of stock markets the world over. But, it won't come without a cost; high incentives will lead to investment in research, brokers and traders, which also opens the door to sales practice abuses and company failures.

The question America needs to answer: are consumers better served with higher transaction fees that fund an economic resurgence that leads to growth in employment, growth in the economy, higher tax receipts, which improve the ability to hire teachers, firemen and police, lower budget deficits and higher overall returns on investment? I want everybody to imagine for a second, a stock market where the cost to buying and sell stocks approaches zero. There would be little to no incentive to provide research, little to no sales support for stocks and little to no capital commitment by market makers. The only stocks that investors would embrace would be naturally visible, big brand and large cap stocks. The vast majority of the rest of the market would wither on the vine of inadequate support and a lack of liquidity; the place that we find ourselves in now. The good news is that people are beginning to recognize, to paraphrase James Carville, it's the incentives, stupid. The bad news is that so far the bills making their way through Congress to address the crisis in capital formation focus exclusively on cutting costs for issuers and opening up the private markets to pick up the slack of a failing public equities

market—bills like H.R. 1070, 1965, 2167, 2940 and 2930—a few of these ideas actually were plucked out of our papers, including "A Wakeup Call for America," which was published back in November of 2009, if I'm not mistaken.

This tact will not lead to seismic resurgence in equity capital formation that America needs to kick start the American dream and create millions and millions of jobs. The clear and obvious culprit, as seen in this chart, it's an important chart, is the loss of economic opportunity required to compensate investment banks to take small companies public and to keep supporting them. Underscore the word—keep supporting them, in the aftermarket. Here are the sub-$50 million IPOs, seen in purple, abruptly fell from 80 percent of the IPO market to 20 percent almost overnight and, due to the one-two punch of the Order-Handling Rules of 1997 and Regulation ATS, Alternative Trading Systems, which is the birth of electronic stock markets in 1998. And the effect of these two was to really kill the aftermarket economics, the IPO spreads were not touched. Rule changes gutted the economic value of the associated aftermarket trading and made small IPOs unprofitable, and this was fully four years before Sarbanes-Oxley, which as you can see from the chart, was not until 2002.

Here we index the number of listed companies and major industrial markets to 1997 when the Order-Handling Rules went into effect, and you see China, Hong Kong, Australia, Germany, Tokyo, Toronto, Canada, London and the United States—the United States on the bottom. And what you see here is the slow and steady loss of 45 percent of all listed companies from the United States' stock markets. Okay, imagine the depressive effect that this has had on the U.S. economy. There is no free lunch and this is true of stock markets. You cut transaction costs too far, firms can't make a living, and you throw the market into systematic decline and create a job-killing engine. This view is shared by many active and former stock exchange officials, including senior executives of the New York Stock Exchange, Euronext, NASDAQ, OMX and the London Stock Exchange.

In each of the successive slides, you will see that the left side of the circle begins with a series of rule changes that attack the Wall Street economic model and ends on the right side with decimalization. Sarbanes-Oxley is outside to the right of the circle. The line you see is unemployment here. As you can see, as the IPO market falters unemployment goes up. In this slide, we simply borrow from the premise held by economists, that if we kept market structure constant, that the supply of IPOs would grow in line with GDP. So, we assume a three percent GDP growth rate and conclude that the United States would have produced over 900 IPOs in 2010 versus the less than 200 that have actually been produced. If you assume that each of these jobs would have the median number of 1,117 jobs per listed company—of the listed companies and this is the median equity market value company of a listed—a listed company in this country is microcap by institutional standards—it's only $450 million in market value—you get an opportunity cost of almost 10 million jobs which could have helped to drive today's unemployment rate to below five percent. And, while you can attack this analysis for overestimating the employment per IPO, the counter argument is that a strong IPO market would dramatically increase the rate in investment in private enterprise, which by all accounts, is the bedrock of job formation, as we've heard from at least two or three of the Commissioners today. And, there is no multiplier effect that is being taken into account for the impact that these companies would have buying goods and services in their local communities.

In addition, we saw a venture capital boom during the dot com bubble but never enjoyed a subsequent IPO echo boom. And as you can see through 2000, the great growth in venture capital moneys raised and you can see the dud of the echo, if you will, in the bull market years of 2004 to 2007. Comparing the breakdowns of IPOs from 1991 to 2010 in these two pie charts, you can see that the mix of IPOs just hasn't changed much, just the numbers. The problem is not confined to venture capital, it hits every bootstrapping entrepreneur and mom and pop that ever aspired to one day run a public company, the American dream. While this may be an aside, it should be pointed out that low cost self-directed trading caused the dot com bubble and not renegade analysts. I'm not saying they didn't help, getting on TV, but if you look at it, the Internet, combined with the Order-Handling Rules and Reg. ATS, added fuel to the opening of self-directed accounts in the dot com bubble. And the numbers here, we use the number of E*trade accounts pulled from their—from E*trade's—10K's, it's a proxy for the growth in the self-directed market during this period.

Ironically, despite the Spitzer decree and costly rules governing analysts, stock recommendations still have no predictive value, according to a former executive at the analyst rating shop, StarMine. Zero predictive value. These rules have added great cost to the system and deprived investment banks and investors of their best new issued due diligence and educational asset, which is research analyst, all at zero measurable gain to the consumer. For this reason, we call for the repeal of rules emanating from the so-called Spitzer decree and the renaming of equity research as information sales. All people in the industry understand that it is the analyst job to make money for the firm and the conflicts of maintaining relationships with large cap executives in major institutions, create an environment where analyst recommendations must be hedged to sustain the analyst's commercial viability. The public must be let in on the secret and the analyst must be reengaged for the benefit of economic growth.

Here, I am going to run through a series of slides that demonstrate beyond a doubt that it is market structure and the loss of economic incentives that have destroyed the IPO market and not cost borne by issuers, which is not to say that costs don't have an inhibiting effect, it's just to say that the bigger problem is these costs. Each one of these slides is a lack of incentives, each one of these slides consists of a 30 IPO trailing average, companies that have all filed with the SEC and thus already incurred the cost of filing an IPO. Here you can see that it now takes three times as long to make it through the SEC as it did 20 years ago. While some say that this is part due to a lack of responsiveness on the SEC, many believe that it is, in large part, due to the increase in stock market volatility due to market structure changes. It is increasingly difficult to find a window to get a deal done. Here we have a composite of all IPOs and their success rates. A success is a happy outcome for an issuer, which occurs when the IPO is priced within one year of filing, at or above the low end of the IPO filing range, and is still trading at or above the issue price 30 days after the IPO. And, as you can see, IPO success rates have been cut in half, despite the fact that the median deal today is for a much bigger and more mature company. Res ipsa loquitur. But as you will soon see, this horrific trend of markets failing to support issuers is true for every IPO, even every sized IPO, even large IPOs. Small IPOs, this is sub-$50 million are failing at faster rates. $50 to $100 million IPOs, $100 to $250 million IPOs, $250 to $500 million IPOs, and the shocker is that even the largest IPOs, which is greater than $500 million, have displayed the steepest decline of all. Okay?

So, in fact—the fact is that Wall Street can no longer afford to distribute IPOs to critical mass numbers of investors, because the revenue opportunity in the cash equities business is insufficient to sustain the standing infrastructure needed to support critical mass investment in research, sales and liquidity facilitation. And to dramatically make this point about the loss of infrastructure, one need only compare the syndicate of underwriters on the $58 million Microsoft IPO in 1996 to the much larger $352 million LinkedIn IPO of this year. Microsoft, which was led by Goldman Sachs and Alex Brown, the latter no longer in business, had a total of 116 underwriters. Here they are. And contrast this to LinkedIn which had only five firms at $352 million. I'd like to close with a call to action and an issuer's bill of rights. As you can see, public stock markets need help to welcome better issuers and to provide adequate incentives for the next generation of entrepreneurs to go public. So we believe that issuers deserve to know who is trading in their shares both long and short. We believe that issuers deserve a choice in how the market in their shares is made and supported. And so we are calling for issuers to be able to choose their tick size, that's their spread size. This might also have the advantage of dampening speculation and volatility in restoring consumer confidence in stock markets. We believe that issuers need increased representation within the Division of Trading and Markets and that the Division must develop a discipline in the impact on small companies, because more than half of all listed companies are microcap by institutional standards. Interestingly, institutional investors and stock exchange executives generally agree that the electronic market structure has really depressed liquidity for small, micro- and nano-cap stocks; this section of the stock market where job growth lives.

And finally, we believe that America needs a new stock market structure to serve the needs of the sub-$2 billion market cap companies and put the focus back on capital formation and job creation. To quote "Field of Dreams," "If we build it, they will come." If we build back incentives, entrepreneurs will breathe life back into the American dream. Thank you.

[applause]

John Coffee: David Weild's a very smart guy, and I agree with some of the things he's saying, but not all of them. David, like everyone else who's discussed this topic recently, starts the same way and says smaller IPOs are disappearing, maybe even vanishing. And then comes step two. This development is a signal of distress. It's a crisis. It means there's a canary in the goldmine. That could be a classic non-sequitur.

Here's the alternative interpretation. And both interpretations should be compared with each other. The alternative interpretation is that the rational entrepreneur has shifted from public markets to private markets and did so beginning about 15 years ago. And, we've seen a fairly steady performance since then. But there was a massive shift 15 years ago from IPOs to private placements to raise capital for the smaller firm. Based on that shift, and here's the basic policy point I'm making, the goal should not be to bring back the smaller IPO. The goal for the SEC should be to assist entrepreneurs to raise capital, including equity capital, by the most efficient, low-cost means that is also consistent with investor protection. And I think that in many ways the future will probably remain with Reg. D private placements and other alternative mechanisms.

Now let me just go through this slowly and look at some of the evidence with you. If you ask "Why has the smaller IPO gone away?" One reason of course is obvious. We all agree there are high fixed costs to an IPO and a small IPO is going to be very inefficient to raise capital in that fashion. That high fixed cost, any inefficiency—you're spending a lot of money for an IPO—that's only reason one. Reason two, equally basic, is that institutional investors, who are the party that buys IPOs or at least get the allocations on hot IPOs, demand secondary market liquidity. They cannot get that liquidity in smaller IPOs. They tend to have a rule of thumb that they want to see a secondary market capitalization at somewhere around $500 million before they'll have the liquidity that they want. That preference, which is a buy side preference rather than a legal rule, that preference means that many entrepreneurs are delaying their IPO and doing additional rounds of private placement or venture capital finance until they get to the scale of where their IPO will be attractive to institutional investors and they can get that first day pop that they want.

Now, if smaller issuers are achieving their goals more cheaply by using private markets over public markets, that probably implies that some of the bills now pending before the House or that have gone through the House and that seek to create a new alternative pathway into the public markets may not be used even if they're created. I have a quote in my paper that is exactly the same quote that David ended with, and it wasn't meant to be a critique of anything he's saying, but there's this famous baseball movie "Field of Dreams," where a disembodied voice says, "[B]uild it and they will come." That may be true in baseball, probably not true in securities markets. You can build it and no one may use it if they're happier doing it a different way that works for them and involves lower costs or has other advantages. And here let me make a reference to the real world. This was partly in Elisse Walter's speech. She pointed out that in 2010 something like $905 billion was raised under Reg. D, and that number probably undercounts. Another way to state that, and this is in a slideshow that Mr. Lewis, the SEC's Chief Economist has prepared: since 2009, two years ago, since 2009 to a very recent date, there have been something like 37,000 Regulation D offerings, 37,000. And, the median size was roughly around $1 million. That means an awful lot of money is being raised under Regulation D—whether it's 506, 505 or 504 that's secondary—it's being raised under Regulation D. If we go back from 2009 to the date when this study was done, it's probably about 1,000 days. And, if you divide 1,000 days into 37,000, it means there's like 37 of these Reg. D offerings being done a day. And again, these numbers undercount, because as we all realize, lots of issuers don't like to bother filing that Form D under Rule [5]03. And there's no significant penalty when they do not do so.

So, I'm suggesting that the world of private equity markets probably is the principal source for the smaller public—the smaller company. This does not mean that I'm telling you, Congress should not pass bills that give issuers alternative options. I, in fact, think that some of these bills, such as H.R. 1070 which would expand the 3(b) exemption from five million to 50 million, makes sense. I think, particularly, useful would be H.R. 2040 that would remove the general solicitation prohibition, which is something like a vestigial appendix. To the extent people are obeying it, it is at least an obstacle, and I don't think it has any significant function.

Okay, now let me just tell you what I think has happened over the last 20 years, using the same chart that David was using. David used that wonderful chart that showed that smaller IPOs didn't gradually erode, they didn't decline slowly, they went off a cliff. And the cliff was the years 1998 and 1999, and they went from over 80 percent to under 20 percent, and that 20 percent level has more or less remained stable since then. We're now at about 17 percent. What caused all that? A drop that sharp can't just be slow erosion, slow changes in costs. Well, David gave you his explanation: Regulation ATS and the Order Handling Rules. And, that could be part of it. There can always be multiple causation. Another thing that happened though, is the comparison between the private market and the public market. Private markets always have lower costs. Private placements are cheap. But there was a problem with private placements. The purchaser faced high illiquidity. When I was a young lawyer, billions of years ago back in the '70s, the typical holding period when you bought private placement stock was three to five years. Then we got Rule 144, and it was shortened to two years. But two years was still a significant period of illiquidity. Then in early 1997, the SEC changed the requisite holding period under Regulation D from two years to one year. That was finally adopted February 1997. And the next year, we see a dramatic change. Issuers seem to be less using IPOs and moving very significantly in substitution over to private placements. Now, I can't prove that's a cause and effect relationship, but I can tell you it's a very strong correlation. And, we know that the private placement market has grown, and I think it's grown largely because illiquidity was the principal cost and that cost was greatly reduced. Okay. Notice also here that we can't blame this all on Congress' favorite whipping boy, it was not SOX. SOX is 2002. It has nothing to do with what is going on in '98 and '99 up to 2000.

All right, so the policy issue, as I see it, can be simply framed this way. If smaller issuers prefer to use private placements to IPOs, is that a problem or is that a solution? I think it's more part of the answer than it's part of the problem. But I'm not against giving them alternatives. Against this backdrop, let's take a quick look at the principal bills that have now gone through the House of Representatives, sometimes by overwhelming votes. First of these is H.R. 1070, which would move the 3(b) exemption under the '33 Act from five million to 50 million. This is probably, in my judgment, the best crafted of these bills, because it does not really reduce investor protection. It requires an SEC-approved disclosure document. It enables the SEC to provide for periodic disclosure after the offering as they see fit, and it's backstopped especially by Section 12(A)(2), meaning there would be real liability, negligence-based liability for this. And it even requires audited financial statements, which are stronger than the traditional Regulation A. Regulation A itself, traditional one, has withered away. There were only seven such offerings in 2010. But with $50 million here, we could see some greater use of Regulation A.

What do I think will be the real impact? Let me suggest to you that there's going to be a hidden impact here. If we raise Section 3(b) from five million to $50 million, as probably we should, the hidden impact is this. 3(b) provides the legal foundation not only for Regulation A, but also for Rules 504 and 505 under Regulation D, which are not founded on the private placement exemption. Thus, there will be strong pressure on the SEC, pressure that I think ultimately they will acquiesce in, to also move up—if 1070 passes and we go to $50 million underneath 3(b)—to also move up Rules 504 and 505 from their current limits, one million and five million, respectively, to five million and 50 million. That's going to produce a number of new opportunities, and the question will be will issuers prefer to do an inflated Reg. D offering under

Rules 504 and 505, or an inflated Reg. A offering under this new 3(b) that will be passed. I suspect that many of them will prefer the private route. Why prefer the private route? It will not give you 12(a)(2) liability, because that does not apply to private offerings. And it will not give you SEC oversight. Think if you were the next small Groupon. As that next small Groupon, you have very novel accounting, which the SEC properly was skeptical of. You can either go the public route and expose your novel accounting to SEC oversight, or you can keep it private and do a private placement. I think many will prefer to do the private placement and to avoid the higher liability. The only advantage of doing the Reg. A route is that you could have a general solicitation, but that also can be changed by other bills that are pending. And, you would not have to comply with a 35 purchaser limit, and that, too, could be reexamined. Okay.

Next bill that's pending, H.R. 2040. It permits a general solicitation under Rule 506, if the issuer limits a solicitation to accredited investors. I think that's sensible. I think that's important, and I think that could easily be combined with some additional rules about the use of websites. And this would let you get the useful, efficient part of crowdfunding, without allowing all kinds of strange, deviant individuals to start marketing securities anywhere, anytime, under the guise of calling it crowdfunding. So, I think that, of all the bills, I think the one that will do the most, and do the least harm, is 2040, which would permit general solicitation on private placements.

Now, let's briefly say a word or two about crowdfunding. I'm the deviant here. I think this is a catchy, fashionable idea, very internet friendly. Tweeting for investors. The problem is if you actually look at the statute, it says very little about websites. What it says is you can do the following without any of the following. You don't have to have a disclosure document, you don't have any restriction on selling this through broker-dealers, you don't have any state law that's applicable. What do I think would really happen? Not a wonderful world of websites—that could happen too, but you can do it other ways—I think what would really happen if the crowdfunding legislation, as it has been drafted and passed by the House of Representatives or to pass Congress, is that in every barroom in America there would be a slightly deviant character, vaguely resembling Danny DeVito, if you remember the old taxicab show, who would be hawking securities on a nightly basis to every other patron in that bar. And this would all be underneath both the SEC's radar screen; states would be preempted. No one would pay any attention to this, but it would add some stigma to the securities marketing process. My point here is not that we can't made ready use of websites but legislation can create a very overbroad exemption, and we would totally strip state regulators who are the one body who will watch this, because I think the small size of crowdfunding offerings will always be well below the SEC's radar screen.

Okay, last couple of points. We also have the issue about Section 12(g). You've heard that there's a desire to raise it either to 1,000, or to broadly carve out special categories, such as, for example, bank holding companies. The problem is not that there should be no change, not that 500 should be the limit. The problem is that shareholders of record is an out of date, obsolete concept in a world where most securities are held in street name. I'm happy to see some increase in what the limits are, but we should look for a better criterion. I submit to you the better criterion is not to count shareholders of record, but to look to the public float requirement. That's what the SEC did when they adopted the eligibility rules for Form S-3. There, they said if you have a public float, that is stock not held by affiliates, of $75 million or more, then you can

use this more expedited procedure, the Form S-3 with its shelf registration. Now, I'm not saying $75 million should be the standard. It could be 75, it could be 100, it could be 150. That can be debated. But if you use a public float requirement, we eliminate the possibility of gaming behavior. What could happen in the near future, if we move the numbers up to 2,000 for bank holding companies, what could happen there is it would be possible by insisting that shareholders hold, through a street name broker, to have a bank with a market capitalization of three, four or five billion and with maybe 2,000, 5,000, whatever beneficial owners, still have shareholders of record of below what the numbers, 2,000 or 1,000, below that level. You are inviting gaming behavior that will create large institutions which will be opaque and non-transparent. I think, if we learned one thing in 2008, it's that we need more transparency with regard to large financial institutions rather than less. And, I think we can have the desire for an adjusted limit on when you become a reporting company without using something as overbroad as a shareholder record requirement which can be outflanked and gamed by those who really want to.

So, I'm giving you some suggestions. Basically, my theme is, for the Commission, focus on how you can get the small entrepreneur to get access to capital more cheaply, more efficiently, but don't create overbroad exemptions, whether it's the shareholder record requirement or crowdfunding, because I see really no great need to allow people who are neither brokers nor investment advisors to be in the business of marketing securities. I think that's just going to invite systematic abuse over and over, and at that point, I think I've just hit my time limit. Okay.

Meredith Cross: Great job staying on schedule.

[applause]

Meredith Cross: And those are all things we're worrying about, I'll tell you that. We've had those conversations over and over again, and we will continue to. So next up we have Greg Wright.

Gregory Wright: Thank you. Good morning, everyone. I'd like to thank the Chairman, the Commissioners, the staff, moderators, everyone who's worked to put this day together. Much appreciated. It's encouraging that we have practitioners here to debate these issues. And I think there will be a debate. I think, I disagree with almost everything Professor Coffee said.

[laughter]

Gregory Wright: I'm here to talk about challenges facing investment banks, focusing on growth sectors in the economy. I think the slides are down. Okay.

While that's happening, I'll just talk quickly about the agenda for my remarks. I'll talk quickly about who we are at ThinkEquity, since many people might not be familiar with the firm, why small-cap IPOs matter, the critical challenge facing us in supporting these issues, the origin of these challenges and a proposal to address. I acknowledge this is a very quick skim of a complex topic. Who's ThinkEquity in this sector system? We are a growth oriented entrepreneurial service investment bank, focused on growth sectors of the economy. We have our headquarters

in San Francisco, offices in Boston, New York and Chicago. We're about 120 people. We're focused exclusively on the sectors of greatest interest to venture capitalists. Sectors are shown at the bottom of this page. The coverage of our research team by sector in the pie chart. And the distribution curve shows the skew of companies by market capitalization that we cover. Our median today is $1.4 billion. That would be at the small end of what you would see even at a small bank at a tech focused boutique.

We've been quite active in capital markets transactions through this current market cycle. We did a couple of IPOs and a registered direct in this last two weeks. Some more transactions. Why market structure matters. Context of the remarks that follow. These are points often made and often evidenced. I'm not going to provide the evidence here. I'm pleased to talk to people as we go through the day about any of these, where the linkages do need more explication. IPOs are no longer a viable exit route for many smaller tech and life science companies, which drives M&A exits of portfolio companies that in earlier cycles would have gone public.

To Professor Coffee's remarks, the million dollar median that a private placement may supply does not satisfy the several hundred million dollar exit that a venture capitalist seeks if they're going to make that venture capital investment on day one. And this lack of IPOs, and these forced M&A exits, negatively impact U.S. innovation, competitiveness and job creation.

Focus today on one issue out of the many we could be talking about, and that's the profitability of secondary trading. I'm going to focus on this because I think it is a core issue to the question of why we've seen the IPO markets decline. The lack of profitability in secondary trading has a number of effects. One of which is it forces investment banks to shift their focus to higher capitalization ranges. While we focus on some of the smallest companies of any of our competitors, our $1.4 billion in median market cap from the prior chart is up dramatically from $900 million only two years ago. That was a conscious decision we made essentially to make the firm more profitable. The lack of profitability in secondary trading deprives smaller, newer companies for the research and market support that they would otherwise have. Companies with limited or no research and limited market making become orphans. The reason why institutions prefer companies with $500 million or more of market cap, which is certainly true as Professor Coffee said, is not because they prefer institutions with over $500 million in market cap, it's because that's the level at which some liquidity support, some market making, seems to have began to occur. If we had different spread policies, however, we could move that threshold down significantly, much to the benefit of IPOs and the economy. This lack of profitability in secondary trading drives institutional investors up market cap more every year and more every time there's a shock or liquidity crisis.

And finally, it's a self-perpetuating cycle, and it furthers the perception and reality that smaller companies will not have the institutional following they require for IPOs. Right or wrong, when most people are asked, "Can we do a $50 million IPO?" They're told, "No, you will not have sufficient interest, liquidity or support."

Think about the revenue streams of a business like ThinkEquity. We do primary business, we do secondary business. Today, secondary equity markets business at best is a break even business for any investment bank. The boutiques therefore rely primarily, not on secondary business, but

on primary business. Both the origination of capital markets transactions, M&A advisory, private placements. The banking revenues on capital markets transactions increasingly, as per the slide that David showed, are going to the largest banks. So, that forces us even on the origination side really into M&A and private placements. From a banker's perspective, that's fine. There's as much fee opportunity doing an M&A transaction, as there is doing an IPO, or more. But from the point of view of the economy, job creation and the value that venture capitalists receive before they finally exit their investments, the IPO would have been a much preferable societal outcome.

So what happened? How did the infrastructure get destroyed that used to support these transactions? I'm going to talk about one significant cost, which is decimalization. When we talk about decimalization, it's not the question of is it better to be in fractions or is better to be in pennies? What we're talking about is, what's the appropriate spread that provides enough profitability to firms that they will research and they will support the trading and they will support the aftermarket performance of these issuants. Prior to decimalization, most small-cap stocks had 25 cent spreads. Post decimalization, that one became a one-cent spread. Taking 96 percent of the economics out of a business destroys that business, and that's exactly what happened. It's hard to overstate the impact that this had on our markets.

Some of the effects: capital and people were withdrawn from market making and from research; computers and algorithms were substituted; market making became a client accommodation not a source of trading profits, reducing capital and aggressivity in market making, and reducing liquidity of these companies; research became a cost center, not a source of trading profits, so investment in research was reduced. Many top analysts joined the buy side, taking them out of the public debate. Small-cap stocks and their investors suffered from the reduced attention to liquidity, while the frictionless markets encouraged high frequency trading, speculation and volatility. Small-cap IPOs became much less viable.

What can be done? Make one proposal today out of the many that could be made, and that's give boards of publicly listed companies the right to set their own trading increments. This could be effected immediately and with almost no cost. It would make fundamental research and market making profitable again, pulling people and capital into those activities, lowering the capitalization of companies that would be required for institutional liquidity. This would also, not coincidentally, subject high frequency traders to enough additional friction to shift market participation more to fundamentals and away from some of the algorithm games. Proposals have been made that would increase friction other ways, for example, taxes. That does not rebuild the infrastructure that we've lost and that does not keep companies from simply listing overseas who have that option. As a footnote to this page, I've listed another alternative, which is sometimes included, which would simply be to specify trading spreads tiered to share price of issuers. That would work just fine, too. And probably, in terms of getting something done, putting this determination in the hands of the boards would be easier to effect.

Boards would have a fiduciary duty to set these such that the questions of trading liquidity and support were balanced with the transaction costs for the investors. Small-cap research would flourish, and capital and personnel would return to small-cap market making. Speculating on high frequency trading would be discouraged, longer term fundamental investing would be

encouraged, market volatility and the uncertainty that it represents would be decreased, investor focus in small-cap issues would increase and result in greater research, following and liquidity. And finally, and most importantly, the infrastructure would be rebuilt and the ground work would be in place for a return of the $25- to $75 million IPO, which would enhance innovation, competitiveness and job creation by providing something to the venture capital community they simply can't get through M&A exits or through private placements. Thank you.

[applause]

Meredith Cross: Kathleen.

Kathleen Weiss Hanley: I thank you, Meredith and Steve. Today, I am the Deputy Director of the Division of Risk, Strategy and Financial Innovation here at the Commission and one of our mandates is to provide economic analysis to the Commission on topics of interest. I'm going to give you more of a global perspective with respect to the decline in smaller public offerings to see if whether or not it's regulated to the US or whether it's worldwide. Before I begin, because I am a Commission employee, I have to note that these remarks are my remarks and do not reflect the views of the Commission or the staff. So this research has been ongoing in our Division. It's co-authored with Cecilia Caglio and Jennifer Marietta-Westberg, and we've been looking at what determinants of IPO's that list outside their home country.

So this is a subset—this data is a subset of a sample that we have of 18,000 IPOs that have gone public from 90 countries. I'm going to concentrate on the same countries that David did, those that have the largest domestic IPO market. And as you can see from this chart, prior to the decline of the tech bubble in 2000, the U.S. had a substantial number of smaller public companies, going public less than 50 million in the small IPO market. And after that time period, the decline is quite dramatic. It is not—the decline—we also don't see in other countries—China does have some decline in the number of smaller companies, but the vast majority of companies that go public in China are Hong Kong—are in fact below $50 million U.S. So these are all—proceeds are all done in U.S. dollars.

It is important to note that we—this decline in smaller IPOs is not necessarily due completely to the decline in foreign IPO's, though it has some impact. So, we look at IPOs that list in another country, not their home. You can see that the U.S. was the dominant market for these foreign IPOs prior to 2002. After 2002, however, both Hong Kong—I mean, sorry—United Kingdom and Singapore have increased dramatically. Now you might wonder why China and Hong Kong aren't showing a huge growth here. And that's because in our study, we consider any Chinese IPO that goes public in Hong Kong as a domestic IPO; we do not consider them as a foreign IPO. And much of the growth in the Hong Kong market has been from mainland Chinese companies moving into Hong Kong. Let me go back, if I can. So the decline in foreign IPOs in the U.S. has been quite dramatic with the rise going into foreign markets such as Singapore.

So one might question whether it is in exodus from the U.S. market that is driving some of this growth. Prior to 2002, about 14 U.S companies went public abroad rather than within the U.S. After that time period, that number has increased dramatically to 52 IPOs. But as you can see, it's still not a huge number relative to the total numbers of IPOs that have gone public. Most of

these are smaller; 29 of them are—40 of them are smaller IPOs, 29 of which are going to the U.K., notably, to the AIM market in which disclosure and other restrictions are far less. So, we're not seeing a huge exodus from the U.S. market into foreign markets, indicating that there may be other reasons why U.S. companies are not going public. So what might that be? And both of these things have been mentioned quite extensively on the panel by both Professor Coffee and Mr. Weild.

Certainly the rise of M&A exits, which I'll do actually last. The Advisory Committee on Small and Emerging Companies have indicated to us, to some extent, that the status associated with being a public company CEO has declined. Also, they prefer the certainty of an M&A buy out, rather than the potential uncertainty of a public company offering. And as Professor Coffee mentioned, our Division and the economists —Vlad Ivanoff and Scott Bauguess—have been looking at Reg. D filings after the Commission required those filings to be put in the form of structured data after 2008. This analysis covers both public debt, public equity, which we get from SDC, the Reg. D filings which we hand collect, and then Rule 144A, Regulation S and other private offerings. And as you can see from this graph, the emergence of—or the amount of Reg. D offerings—this is in the amount of capital—has increased substantially over the two years that we've looked at this type of offering. And, it's beginning to overtake public debt offerings as a source of capital.

If you look at all private financings over time, in 2010 the amount of private financing has, in fact, been higher than the amount of public financing. And most of these offerings are Reg. D. These Reg. D offerings, as Professor Coffee mentioned—there's 30,000 of them with a median amount of $1 million, and an average amount of about 30. Most of these Reg. D filings are coming from U.S. companies, but we have a substantial proportion of companies, also, that are foreign that are using Reg D offerings, which may be an alternative to going public in the U.S.

The last slide I'll show is on VC IPOs and M&A exit. Ideally, we would like to be able to determine or to look at companies—private companies—and determine whether or not they're going public, or whether or not they've chosen an M&A route. Unfortunately, we aren't able to have that information. So VCs provide the next best solution to seeing what choice do they use when they're trying to have exits. Not surprising, given the information on this panel, the desire for VCs after 2000 to use the IPO market has declined, and almost is zero is 2008. Indicating that, once again, many of these companies that may have gone public are seeking private or alternate forms of financing. Overall the Commission and my office continue to monitor statistics in the IPO market—the research that has been done, both by the panelists here and by academics. And we look forward to an ongoing discussion regarding the mechanisms that we can employ to facilitate IPOs. Thank you.

John Hogoboom: I guess that leaves me for last. You know, I have to say, I'm kind of struck by the—by what's going on today. I've attended a number of these over the course of many years, and it just feels—I don't know exactly how to characterize it. I guess the best thing I could say is it feels like somebody let the water out of the tub, and everybody's trying to jump into the whirlpool and get sucked down the drain before somebody stops it.

[laughter]

I find myself sympathizing with the SEC more than I ever have before because there just seems to be what I view as sort of a crazy rush to—let's open the flood gates here, and let people do whatever the hell they want to do because the economy is really terrible and if we don't fix this all, it's going to—we're going to end up in a depression, and by the way, the best way to do that is to have an IPO? I mean, it just doesn't make any sense to me, with all due respect. I think Professor Coffee nailed it, which is really too bad because I have a number of colleagues, by the way, who have less than fond memories of taking your class, but—

[laughter]

But you got to give credit—

Professor John C. Coffee: They shouldn't have attended the class then.

John Hogoboom: But you've got to give credit where credit's due. Look—I've spent 25 years as a securities lawyer doing public offerings of all different kinds, and I just don't—I don't see what everybody else seems to be seeing here. I mean, there's not some enormous pent up demand that I'm aware of for people doing IPOs that haven't been able to do them. Yeah, there have been great times when it's been a terrific time to be an investment banker and to do IPOs, and it's really a shame that the dot-com bubble burst like it did. But let's face it—I mean, everybody has really bad memories of that kind of thing happening, and I think that there's a lot of investors out there that are running scared, who don't want to put a lot of money to work in an IPO situation. And I also think that people are kind of missing the general point, which is that we're in a terrible economy. And so, it doesn't surprise me at all that the level of activity is significantly less than it's been in days of yore, when things were better. And it seems to me that it's a stretch to say that doing more IPOs is going to fix the economy as opposed to fixing the economy is going to lead to there being more IPOs. So, I guess fundamentally, I'm here as, I guess, the only—the person who is in the weeds with these people who are out there trying to raise money. Most of my representation is firms like Greg's and other investment banks, but I also represent a lot of investors and partners of mine represent a lot of public companies. So I think we kind of see if it all from everybody's perspective.

I think that Professor Coffee really did nail it, because people are looking for ways other than public offerings, IPOs if you will, to raise capital. And I think that he's absolutely right that if Reg A gets changed, or 3(b) gets amended, that it's really not going to make a heck of a lot of difference. Although with all due respect to the NASAA people that are here—you know, the single best thing the SEC could do would be to have Congress preempt state securities regulation in its entirety, because it's an anachronism and all it does is add cost without any real benefit. And certainly the states—certainly the states could easily be charged as attorneys general to enforce the anti-fraud laws, or even the securities laws on behalf of the SEC. There's no reason why enforcement has to be just federal. But, you know, let me tell you, we spent an awful lot of time and money and effort in my office dealing with state regulatory issues. And you know, frankly, I'm very depressed by the notion that Congress didn't fix that particular problem when the crisis hit in 2008 and everybody had a great opportunity to fix—the way that securities are regulated in the United States.

So, just a couple of—I don't know exactly which way this thing works but—oh, there we go. So just a couple things from my perspective. Clearly, the collapse of the market since the dot com implosion has had a disproportionate effect on smaller public companies. I think that the collapse of the IPO market's been well documented here. But there's obviously, especially with smaller companies, a lack of market liquidity, less analyst coverage, less institutional support. And the biggest problem is that the costs of going public are the same whether you're raising $2 billion or $2 million dollars.

From my perspective, the current focus on venture-backed private companies is great. But I live in a world where I have to deal with companies that are already public, and—again, to the concept of the change in focus here, it's amazing to me that all of the sudden we're talking about taking care of the poor venture capital people when we've been trying for 15 years to get the SEC to do—and Congress to do things that make it easier for companies that are actually public to raise capital. And it's important to note that the—this market we're talking about is bigger than the VC market. According to the people that own private raised, in 2010 there were $37 billion raised in over 1,100 PIPE and registered direct transactions, as opposed to $22 billion in total VC investments per the National Venture Capital Association's 2010 yearbook. To show how this market is skewed toward smaller public companies—close to 600 of these transactions were for companies of market caps of less than $50 million. Almost 900 were for transactions with a market cap—for companies with a market cap of less than $150 million.

As a result of the implosion of the IPO market, smaller public companies have had to—have really had to scramble for capital. You've seen an increased use of the PIPE mechanism as a way for smaller companies to get capital. Registered direct offerings have become very popular since—especially since 2008. Rather than doing IPOs, there have been a number of companies that have gone public through a reverse merger process. I know the staff is not a big—a fan of reverse mergers; I'm not either. But I think that they're—that they do have a legitimate place if they're well regulated. There are these great concepts out there, which I'm surprised are allowed to exist, which are companies going through reverse mergers and raising capital at the same time. It's what we call an APO, or an alternative public offering. And from my perspective, the real story in my marketplace has been that since 2008, investors have required increased liquidity. The number of registered directs and other registered offerings have increased dramatically, both in total and as a percentage of the overall market for capital for small public companies. According to the statistics I have, there were 291 registered directs in 2010 versus 70 in 2001.

Meredith Cross: So is that in contrast to a PIPE? Is that—

John Hogoboom: Yeah. In other words, what's happening is the investors—even though the SEC has shortened up the holding period for 144 purposes—investors just aren't willing to take any liquidity risks in these kinds of markets where you're seeing up two percent, down three percent in two days running. And so they want to have the ability to liquidate their positions if they want—at least the theoretical ability to do that. And so, the PIPE market has gotten really tough. It's really—it's gotten very much more difficult to do a PIPE today than it was a year and a half ago. And it's gotten to the point where almost everybody is doing a registered deal if they possibly can. So what we see—I think it's fair to say what we see is people do PIPEs when they

don't have any other choice. And that's one of the things I want to talk about here. Hopefully I can see that okay—but one of the things that the staff did a few years ago to help out smaller public companies was to adopt an amendment to form S-3 to create what I guess has become known as the "Baby Shelf" rules, which allows listed companies that have a market capital less than $75 million to make primary offerings on Form S-3 subject to a limitation that the amount of securities they can sell has to be less than a third of their public float in any 12-month period.

A couple of problems, I guess I would say from my perspective, or certainly things that the staff could easily deal with would be to eliminate the need for companies to be listed in order to make use of the S-3 form. And the other thing that's become problematic in practice is that under the—the way that the dollar amounts have been calculated, warrants which are frequently issued in these types of deals are treated as if the actual underlying securities that were issued, even though the issuer didn't get any proceeds from the sale. From my perspective, it would be a lot easier and be consistent with the way the registration forms work if you looked at the overall offering proceeds from a given offering than looking at some kind of an artificial calculation that attributes value to a security that may or may not ultimately get exercised.

Just quickly, from my perspective, there's really no reason to penalize unlisted companies. All of these entities do the same kind of reporting, they're all subject to the same kind of requirements; there's no evidence as far as I'm aware of that there's been any disparity in the available information about listed companies versus unlisted companies. It was not part of the SEC's—the staff's original proposal. It was a last-minute change that has never really been adequately explained, at least to my satisfaction. It would be great to remove, or at least increase, the one-third public float requirement. We see a lot of transactions where companies need capital, where investors are willing to put money to work, but companies are bumping up against that one-third float requirement. If you take, for instance, a life sciences company—they may be doing an offering every six months as they get through a particular phase of clinical development. But if they're boxed out by the rule, there's—they have very few options if they need to raise cash, even with investors who are willing to put the money to work.

The lack of S-3 availability results in higher costs and more complex structures for these smaller public companies. We've done a number of transactions where issuers have been forced to use an S-1 to avoid the restriction on the "Baby Shelf" rules. As I'm sure everybody knows, doing an S-1 is way more expensive, takes a lot more time, there's a lot less certainty. The issuers who are able to do PIPEs have to do it at extremely unfavorable pricing because of there being a much greater premium on the lack of liquidity than there probably was a couple of years ago. And what you see is companies that are not able to take advantage of the "Baby Shelf" rules are having to do heavily structured private offerings, exploding debt, all kinds of odd structures because they're just not able to access a registration statement.

One of the other things that continues to thwart smaller public companies trying to raise capital is the staff's interpretation of Rule 415. We've had lots of conversations about that over the years. One of the problems that we—that I have is just not knowing where the staff is right now with respect to 415 issues. We hear all kinds of rumors and different points of view about that. We've heard from time to time that it really is only supposed to apply to toxic deals, yet we get comments on it all the times and straightforward deals where it's not clear to us whether the

staff's really moderated its position. We get comments from the review attorneys all the time that ultimately get resolved at the AD level, which takes a lot of time and a lot of energy that's probably not necessary. It's unclear today how a 415 comment gets resolved. As I just said, it frequently seems to have to go up to the AD level or to the GC's office before we get the resolution that we think we should have gotten at the very beginning. And issuers and investors in particular are nervous about doing deals with—that involve a large percentage of the company's outstanding stock because they're concerned that even if a comment gets resolved, it's going to be a significant delay in the offering process.

I guess you've gotten beat up by enough other people today, I won't add—pile on. I have lots of intellectual reasons why I think that the staff's 415—the application of its 415 interpretation is flawed. Certainly from my perspective, if I have an investor client who's investing in a company and wouldn't be able to sell all of its stock for 10 years if it was the only one trading in the stock, it's hard to see how that's somehow a veil of distribution on behalf of the issuer. So I don't think that the staff's focusing on the right issues. I get the concept that there was a screening test that was put into place, but this is really—continues to be a problem for us, and it doesn't really bear any relation to reality here, where you're talking about institutional investors who are buy and hold investors, making investment reps, in a situation where even under the staff's own PIPEs interpretation, we could have conditioned the closing of the investment on an effective registration statement, and not had any problems from the staff's perspective. And by the way, none of this does anything to protect investors, because at least in the non-toxic situation, none of these people can affect an exit anyway. They're looking for quote unquote "liquidity" for accounting reasons and for market to market as opposed to because there's a realistic possibility they're going to be able to sell their stock in an open market.

One other thing I guess I would—the last thing I guess I'd like to just suggest here is right now Form S-1 prohibits the forward incorporation of information by reference. For people that don't understand what that means, it means that I can incorporate documents that I've previously filed with the SEC, but unlike in the S-3 form, I'm not able to automatically incorporate by reference documents that I file with the SEC in the future. I guess, I get the point that maybe for new public companies it doesn't make sense to allow them to incorporate by reference if they've never done a 10-K, for instance. But certainly once a public company has done a 10-K, there doesn't seem to be any justification for not allowing somebody who needs to use S-1 to be able to incorporate by reference. I mean, the information's available on EDGAR, there's no difference in the type of information that's being made available, and the SEC has more than an adequate opportunity to pull exchange act documents for review and comment. All this really does is penalize smaller public companies. All—they need to do quarterly supplements in a lot of cases, at least annually. I think the advice is typically that they've got to do a post-effective amendment, which means that they may have to take down the registration statement for 30 to 90 days, depending on whether—how long it takes to prepare an amendment, and whether the SEC reviews it. It significantly increased the offering cost and it creates risk—liquidity risk for investors. And from my perspective, there just doesn't appear to be any reason for that to be in existence anymore. I mean, EDGAR's been around now for close to 20 years. I think everybody's pretty comfortable with the information that's available and when it's available, and it just seems to be an artificial restriction.

I guess one other thing that's not on one of my slides I'd just like to get out here is that to Professor Coffee's point, the reduction in the Rule 144 time period for resale has been a huge benefit, and I think it's definitely driven people to be more accepting of private financing. The one thing that would be helpful would be to—for the SEC to further shorten the holding period. I believe it's the case that if you are investing in the—at a prior placement of a company that's listed on the TSX, that after 40 days you can freely resell in Canada. I'm not suggesting that 40 days is the right limit for the U.S.; I'm not sure I'd be comfortable with that as a practitioner, but certainly something less than six months is probably appropriate and would certainly make it that much more cost-effective for companies to raise money. One of the debates that we had at the time that the SEC amended Rule 144 to lower the time period to six months is whether people would still require registration rights agreements in PIPE transactions, and it turned out the answer was yes. I think that if the SEC was able to reduce the 144 holding period to something like three months, the answer to that would probably be no. Because by the time that somebody got a registration statement prepared and filed—and through the SEC, it would probably— you'd probably be at the point where you could freely resell under Rule 144 anyway. I think it's probably fair to say that in most of the deals we do, there's a 90 day effectiveness requirement, and so the investors are aware of the fact that they're going to have some illiquidity. But that 90 day period would probably eliminate a whole set of documents that would need to be negotiated in most of those transactions.

So I realize it's not quite as much ivory tower as Professor Coffee and Mr. Weild, but from my perspective as the guy down in the trenches, these are the things that I worry about that would be on sort of my Christmas list of things I'd like you guys to do to make life a little easier for us.

Meredith Cross: I appreciate the suggestions and one question I have for the panel in connection with the—re-looking at the rules as they relate to companies that are below the well-known season issuer level—I know WKSIs have very much freedom to communicate in connection with offerings. Does the panel think that those sorts of—the restrictions on communications in connection with offerings that apply to non-WKSIs are a problem? Does it make sense to look for ways to allow for more communication? For example, pre-offering, pre-filing term sheets, pre-filing documents for companies that are not WKSIs?

John Hogoboom: You know, from my perspective I don't think I've yet to represent a WKSI. But—so I'm sort of interested to—I don't really know exactly how much the WKSIs take advantage of those pre-filing communication rules. But a lot of the deals we do that are public are marketed on a confidential basis for a lot of different reasons, not the least of which is that nobody wants to blow up the stock price if a company's basically out there in the market for new offerings. So, it might be useful to be able to provide information. For instance, in life sciences companies with clinical results, the investors frequently want to see back-up for the clinical results, and we have this tremendous discussion sometimes about whether you can give people access to that stuff. And, if so, how, and does it constitute a free writing prospectus? You know, being able to do more of that would be helpful. But the idea of actually being able—for public companies, at least—to be able to go out in advance and publicly tout that you're about to do an offering is not something that I think people would take advantage of, even if they could, because it would have so many other tremendous impacts on the trading price of the stock of the issuer that you're talking about. And I was going to make that point with respect to general

solicitation as well. I mean, a company—a public company that's going to do a private placement is never going to engage in a public solicitation—a general solicitation. It's just not the way that those deals are going to get marketed because of those concerns about protecting the stock price and making sure that you can actually do a deal before you go through the process of disclosing that you're going to do it.

Meredith Cross: Although that could work for the 144A debt market, for example, which is—

John Coffee: I just had one point—I think you have to worry a little bit about consistency. If Congress does expand the Reg A availability up to $50 million—Reg A has one distinctive feature. You can do a test the waters solicitation. And I don't think you should create distinctions between a straight offering and a Reg A offering, both of which are public in character, with one of them being incentivized to do one so you can go do a test the waters solicitation. I think you should probably make both of these fairly consistent.

David Weild: Meredith, it would be terrific if we could not have to worry about conditioning the market, and we advise companies going public. And I think that a lot of the stocks that are actually working the best are the ones where the brands are so large that they essentially are able to circumvent any prohibition against general solicitation because of the great name recognition that they have, and everything else is suffering. And if you—the numbers that we had on IPO success rates, which I think you got to look at. I mean, you have to be incredibly disturbed by those trends over the last 15 years.

I wanted to just briefly say, Jack, I did a poll for an institutional investor conference of buy-side traders—40 buy-side traders—and they all felt that large cap stocks' liquidity had been improved that it had been decimated for smaller, micro-cap stocks. And this was just a show of hands. Dan Case, who was CEO of Hambrecht and Quist—before he died in 2002, called me, and told me that one of the reasons they sold Hambrecht and Quist was because of concerns about the order handling rules, and the loss of profitability of the cash equities business. Kevin Cowan, who is president of TSX, and David Topper, who was just formerly globally head of ECM at J.P. Morgan, both told me that they thought that in order to sustain liquidity, the way markets have become so efficient, you needed a half a billion dollars in float. And so, if you're looking at these M&A sales numbers—I mean, people have adjusted in the venture capital round. The first question out of a venture capitalist's mouth today is "Who am I going to sell you to?" It's not, "Am I going to take you public?"

So, I think we—what we've done is if you look at the statistics, I think the market is behaving rationally to some degree, people are just choosing to avoid going public altogether and so coming back to your question, I mean, any way that we can go out and take risk off the table by having discussions, giving people a safe harbor to have a conversation with institutional investors to get that direct feedback from the market, I think would be terrific.

John Hogoboom: You know, Meredith, I just want to say one last thing about this, I mean from maybe my colleagues out there in the audience will kill me about this, but I just don't see what the big deal is about a restriction on general solicitation. I mean, I heard what the person from Silicon Valley said. You know, frankly I had some real questions in my own mind about why

they do things the way they do it out there. There's a lot of things that happen on the West Coast that I don't think would play very well in New York among other places, but you know the—as a practitioner, I want to have some control over the process and I want to know who's talking to who and what they're saying.

If people are allowed to make general solicitations, then I don't know who's talking to who or what anybody's saying and I have to worry about, okay did information get to somebody and now I've got to make sure it's reflected in my prospectus or file it in an 8-K or something like that? It's not clear to me that at least for companies that are already public that there is some big pain threshold that's involved in limiting the ability to do a general solicitation. I mean, it's easy enough to figure out who the people who are likely to be investors in your company. It's just not that hard. And, I think that it's concerning to let the fox into the henhouse. Maybe, you say, okay, you can solicit everybody but only accredited investors are going to buy, but what about all those other people who were told what a great investment this is? They're going to be out there in the aftermarket either buying stock in the trading markets or on some of these shadow secondary markets who basically weren't in a position to be able to evaluate the quality of the information that they were told. So, I mean, you know, people may want to string me up for this, but I just don't see how that's a good idea for the marketplace. That doesn't seem to me to solve anybody's problem here; it doesn't affect anybody's legitimate ability to raise capital, in my opinion.

Meredith Cross: I think a lot of the requests for that change are for non-public companies, just to be clear so—anyway, I think with that we've used up the time for our panel, I'm—we're going to hear from Commissioner Paredes who I'll introduce in just a minute. I want to thank you all very much for you participation today, it was a great panel and I—Gerry will tell us what's next, I guess after Commissioner Paredes talks. So now I'm going to go over there.

[applause]

Introduction of Commissioner

Meredith Cross: All right, so I'd now like to welcome Commissioner Troy Paredes. Commissioner Paredes joined the SEC in 2008. Before his appointment, he was a tenured professor at Washington University School of Law in St. Louis, where he taught and researched, primarily in the areas of securities regulation and corporate governance. Commissioner Paredes has researched and written on numerous topics such as executive compensation, hedge funds, private placements, the psychology of corporate and regulatory decision-making, comparative corporate governance and the development of corporate governance and securities law systems in emerging markets. Commissioner Paredes' scholarly work, among other things, has advocated for rigorous cost-benefit analysis when regulating and emphasized the need for accessible and understandable disclosures that investors can use effectively. Commissioner Paredes is also a co-author with Louis Loss and Joel Seligmen of the current securities regulation treatises. Before joining the faculty of Washington University, Commissioner Paredes practiced law at prominent national law firms, handling a variety of transactions in legal matters involving financings, mergers and acquisitions and corporate governance. I can also tell you that when you meet with Commissioner Paredes to talk about a rulemaking, he makes you go back to first principles and

you really have to go back to when you were in law school   It's exciting and challenging. So with that, please join me in welcoming Commissioner Paredes.

[applause]

Remarks by SEC Commissioner Troy Paredes: Thank you for the kind introduction. It is no surprise that this year's Forum on Small Business Capital Formation has carried on the tradition of earlier Forums in bringing together a terrific group of participants to discuss how we can best promote small business.

A great deal of gratitude is owed to all of those at the SEC—especially, Gerald Laporte—for their efforts in organizing this important event. I also want to thank our distinguished panelists.

I am pleased to have this chance to share with you some of my own thoughts on small business. The underpinning of my remarks this afternoon is this: Ensuring that small and emerging businesses can access the capital they need to start and grow is essential to spurring economic growth and to maintaining and furthering our country's competitive edge in an increasingly global marketplace.[9]

* * *

Why does small business matter so much? For me, four answers jump to mind most readily.

First, startups and maturing businesses create new jobs and opportunities for people.

Second, small business drives new innovations and technologies that lead us to work more productively; that enable us to transact more efficiently; that allow us to relieve and remedy illness and hardship; that permit us to communicate and network better with each other; and that empower us by making us more informed.

Third, in providing our economy with cutting-edge goods and services, new and smaller companies are a vital source of competitive pressure that disciplines larger enterprises to run themselves more successfully.

Fourth, small and emerging companies provide opportunities for investors to earn higher returns and to accumulate wealth—core investor goals—by expanding the investment options investors enjoy. Investors primarily invest so that they can earn income and build wealth. This means that investors need opportunities to invest, and that investors are better served when offered more choices. Small business capital formation not only allows small businesses to start and grow, but it also affords investors an expanded mix of choices for putting their money to work. In other words, promoting small business is part and parcel of fulfilling the desire of investors to commit their financial resources to valuable investment opportunities.

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[9] The views I express here today are my own and do not necessarily reflect those of the Securities and Exchange Commission or my fellow Commissioners.

In sum, small business matters so much because it fuels economic growth and improves our standard of living. As I like to put it, companies that today are household names can trace their origins to entrepreneurs and innovators of earlier periods who had the wherewithal and backing to start and grow a business.

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For a new company to emerge and a small firm to take off, more is needed than an entrepreneur's ingenuity, hard work, and determination. Small business also needs capital.

Raising capital, however, can be costly in terms of out-of-pocket expenses and time and effort. Financial and other regulatory burdens can be particularly challenging for smaller companies. Indeed, by making it disproportionately costly for small business to raise capital, regulatory burdens can create barriers to entry and expansion. This is problematic. For when businesses struggle to get off the ground or grow because they cannot secure funding at a reasonable cost, the economy is deprived of their full participation in the marketplace. In other words, we all lose out when the conditions do not exist for small business to thrive.

* * *

So, what does this mean for the SEC? In my view, it means that we need to consider opportunities to alleviate regulatory demands and burdens that stifle the funding and growth of small business. It means that the Commission should press forward on refining the regulatory regime to allow issuers more flexibility to raise capital privately, and that we need to consider regulatory changes that address the risk that the regulatory regime itself unduly dissuades companies from going public and listing on U.S. exchanges.

Given this, I am pleased by the recent discussions and activity that have centered on such worthwhile ideas as:

- modernizing the prohibition on general solicitations under Regulation D so that businesses can raise funds more efficiently and at lower cost;
- increasing the shareholder threshold at which a private company is forced to report publicly;
- facilitating the use of Regulation A for offering securities;
- facilitating "crowdfunding" as a means for small business to raise capital more easily from individuals;
- allowing smaller companies more flexibility when communicating during a public offering; and
- easing the regulatory burden of being a public company so that going public becomes a more attractive option for smaller companies.

In particular, I am encouraged that several bills in Congress are headed in the direction of promoting capital formation. And I am pleased that the President has expressed his intent to "cut away the red tape that prevents too many rapidly growing startup companies from raising capital and going public."

Also of note is that, in recent weeks, a group called the IPO Task Force presented a number of detailed recommendations to the Treasury Department in a report entitled, "Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth." These thoughtful recommendations deserve careful consideration.

Still more ideas are sure to be offered. For example, I look forward to continuing to engage with the Division of Corporation Finance throughout its ongoing capital formation regulatory review and to considering input from the new SEC Advisory Committee on Small and Emerging Companies. And, of course, the recommendations that grow out of this 2011 Forum will warrant attention.

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As I suggested, I very much welcome the current focus on small business capital formation. But much more needs to be done. We need action. We cannot just talk about small business capital formation; we need to take concrete steps to facilitate it. This includes turning the kinds of regulatory developments that are being considered into actual regulatory change that makes a tangible difference for small business. The Commission itself needs to advance reforms that will open up for small business more efficient, lower-cost pathways to capital. After all, facilitating capital formation is fundamental to the SEC's mission.

Thank you.

[applause]

Gerald Laporte: Thank you, Commissioner Paredes, and thank you to all the panelists in this second panel. I think it was a fantastic panel. Let's give them all a round of applause.

[applause]

Gerald Laporte: We have—those who are participating in the breakout sessions this afternoon—have until 2:00 to have lunch, but before we break, I'd like to describe to you what's going to happen after lunch. Those who want to participate in the breakout group sessions—where recommendations will be formulated to facilitate small business capital formation—should meet in the multipurpose room, which is Room L006. It's to your left as you leave the main doors of the auditorium, next to the stairway down there. You have to come to the multipurpose room because the breakout groups will not be held on this floor, they'll be held on upper floors, but you need an SEC staff escort to reach the upper floors. The security credentials that you receive this morning won't permit you to go on any floor other than this floor and the floor above us.

Those of you who are not at the SEC headquarters who have registered to participate in a breakout group by phone may call in to the breakout group with the telephone number and access code that were e-mailed to you yesterday.

As we break for lunch if—those of you don't know, we're adjacent to Union Station, you can go to one of the restaurants or eateries in Union Station. There are also some restaurants to your left, up Massachusetts Avenue, as you leave the main doors of the building. We look forward to seeing as many of you as possible at 2:00 this afternoon in the multipurpose room where we'll gather to break out into the breakout groups.

And thank you very much for coming this morning. I look forward to seeing you this afternoon.

[End of Record of Proceedings]