

11 excess of a million dollars.

12 So we - in the proposing release, the Commission
13 made clear that they weren't identifying specific
14 procedures that you had to do in a particular
15 circumstance. But rather, look at your -- asking
16 issuers to look at the facts and circumstances of the
17 transaction and make an assessment of what are -- what
18 would be appropriate, given what you know about the
19 purchaser, how you found the purchaser, and the nature
20 of the transaction. Take those steps and make an
21 assessment of what needs to be done.

22 So that's, in a nutshell, the proposal.

23 One additional part of the proposal is that
24 there is a Form D requirement for when you complete a
25 506 offering. You are supposed to file a Form D.

0122

1 What we've proposed to include is a box that
2 you check on the form that would indicate that you
3 are -- you, as part of the offering, you generally
4 solicited or not. This is a way for us to be able to
5 track, identify which offerings, which market
6 participants have been participating in offerings where
7 there's general solicitation.

8 So we can go back and look, after the rules are adopted,
9 to see what procedures are being used, is the framework
10 that we've set up one that works, and be able to look at
11 the market more generally.

12 So that's the proposal. There's a 30-day
13 comment period. We expect, as there was in the comments
14 before we proposed the rule, we expect there would be a
15 wide range of views. Many people have indicated that
16 they're -- that they like the proposal. And as you can
17 imagine, there are a lot of people who said they don't agree
18 with the proposal. So we're hoping to hear from
19 everyone on that.

20 I'm not sure if anyone has any questions on
21 the proposal.

22 MR. WALSH: What are some of the reasons
23 against it?

24 MR. NALLEGARA: Well, some of the reasons are
25 that there should be more definitive requirements. Some

0123

1 are saying there should be more definitive requirements.
2 You should be -- you should be -- there should be more
3 onus on an issuer who's doing a general solicitation
4 deal to have more third-party information, documented
5 information. So there are -- I think there are probably
6 letters on our site that indicate that the issuer
7 should be getting some third-party information to
8 support whether an issuer -- whether a purchaser is
9 actually an accredited investor.

10 MR. WALSH: W-2s.

11 MR. NALLEGARA: W-2s. And there are letters
12 on the other side saying that would grind -- that would

13 grind the 506 offering to a halt, that people just wouldn't -- I
14 mean, if I'm -- if I'm -- I wouldn't want -- you know,
15 it's one thing to provide information to a
16 broker-dealer. I'd be more comfortable, some of the
17 comments are saying, I'm comfortable giving that
18 information to a broker-dealer. But if this provision
19 is designed to allow issuers to access the market
20 without a broker-dealer if they don't want to, if they
21 want to access it on their own, am I -- is a person
22 going to be willing to provide that information just to
23 the issuer that they've never met before? They have no
24 idea, there's certain kind of privacy rights concerns.
25 So there's other comments indicated that if

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1 you're going to allow for general solicitation, there's
2 lots more stuff you should be looking at.

3 The definition of accredited investor, many
4 people have said for a long time that definition is an
5 old definition. You shouldn't just be looking at net
6 worth, you shouldn't just be looking at income. You
7 should be looking at investment. How much money do you
8 have invested in private securities? Is that a better
9 test?

10 And there's Dodd-Frank, which tasked the
11 GAO to do studies that will be coming in the next year
12 that would look at the accredited investor definition
13 broadly.

14 So what the -- what the Chairman's statement
15 at the time of the proposal was, there's lots of
16 stuff within the 506 market, specifically about Reg D
17 generally, that needs to be looked at. The definition. And
18 the form itself, the one where we propose having a box
19 checked.

20 There's lots more information we could ask
21 for. We could ask for -- you know, we could -- we -- a
22 lot of information could be drawn from that that would
23 help us understand what the market is like. All of that
24 is, you know, subject to review.

25 But the terms was Title II requirement, what

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1 Congress asked us to do was a narrow one, so we focused
2 just on that narrow part. So other -- I'm sorry.

3 MS. MOTT: I have a question.

4 MR. NALLENGARA: Yes.

5 MS. MOTT: I can see where in a case where a
6 company that's raising -- a startup company that's
7 raising money, the ruling can apply to both.

8 You know, if they're going to give it to a
9 crowd funding issuer, you know, obviously because you
10 can't tax -- to answer your question, it can bring and
11 attract people who might not be accredited. So you
12 really have to find a way they are accredited.

13 But let's say they're going to generally
14 advertise through this issuer who's online or whatever

15 else, but then doesn't raise enough money, now has to
16 come to, you know, the angel group, let's say, who, by
17 the way, aren't going to give the entrepreneur who's
18 coming to them their information, you know, their tax
19 returns, their, you know, net worth statements, things
20 like that.

21 So in this case, we have the ruling applying
22 over here, but maybe all of a sudden now they're not
23 going -- not going to -- it's not general advertising or
24 it is because it's accredited investors who have
25 invested in, you know, these types of companies before.

0126

1 I mean, I guess I'm a little confused by it.

2 MR. NALLENGARA: I think -- what you're asking
3 is --

4 MS. MOTT: Am I asking? I don't have --

5 MR. NALLENGARA: If you start an offering as a
6 general offering, is that --

7 MS. MOTT: That's it.

8 MR. NALLENGARA: Well, there's a lot of
9 questions on it. We have a number of rules related
10 to -- related to integrating an offering, whether if you
11 generally solicit in an offering and then continue, can
12 you -- for example, you know, real quick, the rule
13 proposal keeps intact the current Rule 507.

14 If you want to do your regular way 506
15 offering where you're not -- you're using a broker,
16 you're using your existing investors, you don't
17 necessarily have to -- you don't have to go through --
18 you don't have to look at this new proposal for the
19 final rule. You can continue to use your established
20 procedures.

21 If you want to generally solicit, that means
22 if you want to have newspaper ads, if you want have a
23 website, then you need to look at the verification
24 standard.

25 What the practices are now currently may

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1 already satisfy that verification. A lot of
2 companies that are doing current practice 506 offerings
3 are using practices that are -- that would be consistent
4 with this verification model.

5 So if a company starts an offering by way
6 of -- by way of a general solicitation, and they want to
7 move back to a sort of regular 506 offering, what
8 they're going to have to look at is they're going to
9 have to look -- it's not as easy as saying, yes, they
10 can do it. They're going to have to look at what general
11 solicitation activities they're going to do and whether
12 that -- whether general solicitation is in fact how your
13 folks for the angel network have been attracted.

14 But I would gather that there's probably
15 methods by which your network could establish
16 accreditation levels for members that would satisfy

17 the requirement.

18 The rule proposal suggests there will likely
19 be third parties that will develop -- that will accredit
20 investors. So SecondMarket has indicated that they --
21 this is an area that they'd like to work in as being a
22 repository of accredited investors. So you could get -- you
23 know, you could get the SecondMarket stance that would
24 say this person is an accredited investor. We've looked
25 at their -- you know, we've looked at their information.

0128

1 They were -- and -- and an investor may be more
2 comfortable providing information to a known entity, whether it's an
3 angel investor or whether it's SecondMarket or some
4 other third party. It would be a way which -- you don't
5 necessarily have to provide that information to the
6 issuer.

7 MS. SMITH: So the company sells shares based
8 on the representation certified by the third-party but it turns out
that the person is a
9 non-accredited investor where -- is there a
10 violation of that rule? Is there going to be a filing
11 rule?

12 MR. NALLENGARA: That's a great question,
13 Karen. The current rule, as well as the proposal, has a
14 reasonable belief standard on it. So if you've taken steps to
verify, and

15 the person -- and the person -- let's say they went
16 through a third party, and the third party is
17 documenting the procedures they go through in
18 establishing whether someone is an accredited investor,
19 and they certify to the issuer that we've checked --
20 we've checked Karen Smith, and we've gone through what
21 our normal procedures are, and Karen Smith is an
22 accredited investor. And I rely on that information, and we find
23 out that you doctored, you gave a fake tax return, I
24 still have a good -- I still have a good 506. It's sort
25 of reasonable for me to rely on this third-party

0129

1 established procedure. I wouldn't lose my 506.

2 Actually, there are a number of cases where
3 individuals who have -- who have faked their accredited
4 investor status, have purchased securities, then wanted
5 to rescind the transaction because they weren't an
6 accredited investor. And they have been unsuccessful.
7 So I'm not sure that was a plan of yours.

8 MS. SMITH: No, not a plan.

9 MR. NALLENGARA: I think we're at 12:00. We
10 have -- for the members we have lunch. And Marc -- I
11 think I saw Marc. Marc Fagel, who's the head of our San
12 Francisco office, was going to talk to everyone about
13 some areas of interest to small companies unrelated to both
14 topics today, but we thought it would be interesting for
15 all of you to hear that.

16 Steve, you want to take ten minutes while we

17 get lunch together, and then we'll reconvene? I think
18 Marc will speak for about 15 minutes, and then we'll --
19 and then I guess sort of have free time back until 1:00.

20 MR. GRAHAM: Perfect.

21 MR. NALLENGARA: Okay.

22 MR. GRAHAM: Let's do it.

23 MR. NALLENGARA: Sorry. So if you wanted --
24 the security is a little different than our meetings in
25 headquarters. So you're obviously allowed to leave and

0130

1 we'll all -- and we'll let you back in. But it's a
2 little more challenging to get back into the building
3 than it is at Headquarters. So I guess for the members,
4 we're going to reconvene in about ten minutes, lunch,
5 and then Marc will speak. And then if you want to
6 leave, you just have to -- you have to come back closer
7 to 1:00. Come back to the 28th floor, and we'll bring
8 you all back down again.

9 For those in the public who want to leave and
10 come back at 1:00, if you can just come back at ten
11 minutes to 1:00, go back to the 28th floor, then we'll
12 come and get you and bring you back down.

13 MS. ZEPRALKA: If any members of the public are leaving
and not coming back for the afternoon session, please hand me your
lanyards on the way out.

14 MR. GRAHAM: Great.

15 MR. NALLENGARA: Back in ten minutes.

16 (Whereupon, at 12:01 p.m., a luncheon recess
17 was taken.)

18 A F T E R N O O N S E S S I O N

19 (12:23 p.m.)

20 MR. GRAHAM: Committee members, time for
21 noontime program. And as I think you know, Marc
22 Fagel -- I guess you're based in San Francisco -- has
23 agreed to spend some time with us talking about some of
24 the -- some of the important issues, I understand, the
25 effect on smaller companies.

0131

1 I think we're going to hear a little bit
2 about -- more about the traffic is going to get worse
3 and essentially how to keep out of trouble. And kind of
4 stay in the terms of time.

5 MR. FAGEL: Well, thank you. Yes, so my name
6 is Marc Fagel. I'm the Regional Director of this
7 office, and I welcome all of you to our new facility.
8 Hopefully things are working -- working well.

9 We've got about just over 100 folks out here,
10 about half of whom do enforcement, the other half are
11 examiners and broker-dealers and advisors in funds and
12 the like.

13 But I'm here to talk about enforcement. And
14 we just thought it would be nice to throw in a little
15 breather during the program and talk about how to really
16 avoid you ever having to be back in this office again.

17 So before I do that, I do have the standard
18 disclaimer that I'm sure my peers agree, which is that
19 the opinions I'm going to share with you are my own. I
20 don't speak on behalf of the Commission or the
21 Commissioners.

22 But I want to talk a little about some of the
23 high priority areas and the sorts of enforcement matters
24 that come to our attention that involve newly public
25 companies or emerging companies.

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1 The -- you know, not surprisingly, one of the
2 top priorities, certainly for this office, but
3 nationally, has long been financial accounting fraud by
4 public companies. And in this office in particular,
5 we're responsible for Silicon Valley, Seattle, Portland.
6 We have a lot of tech companies, biotech companies that
7 are emerging with their own set of accounting issues.

8 And dating back, I've been here about 15
9 years, and, as far as I can remember, that's always been
10 our number one component of our -- of our docket. And
11 traditionally, it could be a quarter, up to a third of
12 the cases we do in our office involve accounting or
13 disclosure issues with public companies.

14 The piece of good news for the folks in the
15 room is that that is way down. And for the last fiscal
16 year, SEC-wide, only about 15 percent of the enforcement
17 matters we brought involved accounting and disclosure
18 matters for public companies.

19 And I can't tell you exactly why that is.
20 Personally, my belief is that a lot of that has to do
21 with Sarbanes-Oxley. And I know that certainly for
22 those of you in the room and in the industry, there are
23 a lot of concerns with Sarbanes-Oxley and the costs. All
24 I can tell you is that the number of restatements and
25 the number of enforcement matters has gone way down in

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1 the last decade.

2 Now, some of that is also just going to be the
3 post-Enron, WorldCom environment where I think companies
4 got a little more careful. I think auditors became much
5 more aggressive, I think boards were more engaged. I
6 think that has no doubt helped quite a bit.

7 I do, unfortunately, have a cynical view that
8 a lot of people have short memories, so I wouldn't be
9 surprised to see that number starting to go back up,
10 certainly as the economy improves.

11 And once again, there's the expectation for
12 companies to reporting -- to be reporting great revenue
13 numbers. I think that's when games start getting played.

14 The piece of bad news I have to share is that
15 to the extent that we do continue to see accounting
16 fraud cases coming out of our office and nationally, a
17 lot of those do tend to be with smaller, newly public
18 companies. I think the quality of internal controls is

19 not quite the same with -- as with an established
20 company. We do see a lot of companies that go public
21 before they necessarily have the mechanisms in place,
22 the internal controls they need to prevent the sort of
23 recurring financial accounting issues we've seen.

24 So some of the classic cases, last day of the
25 quarter, you're not making your numbers, your salesmen

0134

1 are calling all their favorite customers and saying, I
2 know you don't need the product today, maybe six months
3 from now, but let me ship it to you; you don't have to
4 pay, we'll work something out tomorrow, and don't tell
5 our CFO, continues to happens, continues to happens,
6 especially with smaller companies. Tends to happen more
7 frequently I think, at least anecdotally, with companies
8 with offshore operations.

9 So even companies that may have the HQ here in
10 San Jose doing a bang-up job with their internal
11 controls may not have the same focus on what's going on
12 in Singapore.

13 So to the extent there are ongoing financial
14 cases, you know, small companies do need to make sure
15 that they have the appropriate controls, training for
16 their sales staff and finance staff on what is
17 appropriate, what is not.

18 And the top-down pressure always matters. And
19 if you have the CEO and the CFO sending out those
20 e-mails on the last week of the quarter saying, make
21 your numbers or you may be looking for work, you cannot
22 be surprised when games get played to help make those
23 numbers.

24 The -- the other change I've noticed in recent
25 years, in addition to the general decline of these

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1 cases, is that to the extent we do continue to see
2 cases, it tends to be less in the revenue area.
3 Historically, it was always revenue. The analyst wanted
4 to see revenue growth, and that's where a lot of the
5 tricks were being played.

6 These days, I think analysts are a little more
7 attuned to that, companies are a little more careful
8 there, but you do continue to see games being played
9 with earnings management.

10 So the inventory numbers, for example, make
11 your margins look better, make your expenses look lower.
12 So you do continue to see that sort of matter.

13 Another area where we have a lot of focus in
14 enforcement is, no surprise, the Foreign Corrupt
15 Practices Act, or the FCPA. This has definitely been an
16 area of huge growth for enforcement. You look back in
17 the past couple decades that that statute has been in
18 existence, and there were very few cases.

19 It's now -- we're actually breaking out
20 statistics on that as a separate area because it's

21 become so prevalent for enforcement interest. About three
22 percent of our enforcement actions last year involved
23 FCPA violations, improper payments to foreign officials
24 in order to secure business. three percent --

25 MR. GRAHAM: Marc?

0136

1 MR. FAGEL: I'm sorry?

2 MR. GRAHAM: Where there's kind of a hair
3 trigger or are people, in other words, being surprised
4 because they think what they're doing is perfectly
5 normal? I should take that back. It could be normal in
6 that context, but you know what I mean.

7 MR. FAGEL: You know, I'm not sure how to
8 characterize it. You know, as an enforcement attorney,
9 I'm always looking for evidence of scienter. You know,
10 it's not, you know, no one had a clue this was going on,
11 we're shocked. That can still be a violation.

12 But the cases that tend to be more attractive
13 if we're going to have to litigate them are those that
14 have the terrific e-mail where somebody says, don't put
15 this in another e-mail. That happens. There are a lot
16 of e-mails, that is a search term when we are looking at
17 e-mails.

18 So, you know, I can't pretend that there are a
19 significant number of cases where there is obvious
20 knowledge of what's going on at headquarters. You know,
21 you don't -- do not typically have the CFO who says, I'm
22 going to ship you a box of cash so you can get
23 customers.

24 More frequently you'll see very, again, lax
25 controls, where you'll have offshore operations where

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1 they are, for example, asking for tens or hundreds of
2 thousands of dollars for a travel budget and no one back
3 in the home office is paying attention that training is
4 being secured for their new customers at Disney World.

5 You know, so, again, it's more, are you not
6 noticing what's going on? Are you not asking the right
7 questions? Why are we spending so much to run the small
8 operation? And coincidentally, we just got a great
9 government contract out of there and we're flying all
10 these people here for a supposed training in Orlando.

11 So, you know, I think that the internal
12 control issue is a significant one. You really do have
13 to be on top of your offshore operations. What are they
14 doing? How are they securing contracts? How are they
15 accounting for their expenses? Are there slush funds
16 being created so that cash or gifts or other rewards can
17 be made to customers or to distributors who are helping
18 to secure the foreign business?

19 And, again, this is the sort of situation
20 where smaller companies are particularly ripe for this
21 abuse because they may not have the controls. They're
22 growing rapidly. There are mergers happening with

23 offshore operations where they may not have the same
24 controls in place to make sure that they're keeping an
25 eye on these sorts of payments.

0138

1 The bigger problem with FCPA, of course, is
2 that it gets tremendous criminal interest. Now, all the
3 securities laws can be enforced criminally, but the FCPA
4 is one area in particular where the Department of
5 Justice finds them hugely interesting.

6 So in a typical SEC investigation into bribery
7 payments, there will most likely be a parallel criminal
8 investigation. We'll work closely with the Department
9 of Justice. And, obviously, the penalties are much
10 greater. It's one thing to be paying a fine to the SEC;
11 it's another thing for your executives to risk
12 incarceration. So the stakes are very high and the
13 costs are very high.

14 Once one of these things arises, you're
15 talking about doing internal investigation and dealing
16 with a government investigation where all the activity
17 is offshore. And once you have paid a large firm to
18 send a large number of partners and associates to China
19 for six months, those bills rack up very, very quickly.

20 So the stakes are very high; very important to
21 make sure that you've got internal compliance down and
22 you've got training to prevent this problem before it
23 arises.

24 MR. GRAHAM: How often does incarceration
25 occur?

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1 MR. FAGEL: I don't think it happens very
2 often. I think the mere threat of it is enough to avoid
3 the issues.

4 And like I said, it is pretty rare where you
5 will see the scienter evidence arise to a level where
6 you can show a senior executive actually knew or ordered
7 this to happen. But it's not without precedent.

8 And I think one of the bigger threats, it's
9 not so much our authorities, when you're dealing with
10 foreign executives and you're dealing with the foreign
11 government who learns about corruption, and they've got
12 to deal with their own political situation when it comes
13 to light that members of the government are receiving
14 bribes, they may have a different approach to how they
15 deal with executives there.

16 MS. JACOBS: Marc, how do you feel about
17 self-reporting?

18 MR. FAGEL: It's a great question, and
19 something I was exactly going to talk about. I'll talk
20 about it now.

21 MS. JACOBS: Oh, I'm to go --

22 MR. FAGEL: I think it is -- I think it's
23 essential. And I think it can make all the difference in
24 the world in the outcome of an investigation, when there

25 is a -- is self-reporting. But let me circle back to
0140

1 that and talk about it. It's a great question.

2 Let me hit on two more quick areas on public
3 companies and then turn to a couple short ones on
4 private companies.

5 Two additional areas of interest for public
6 companies, Reg FD, fair disclosure. It's a regulation,
7 been in place about ten years or so. There were a few
8 cases right off the bat when we brought it, then it was
9 quiet. Now there's a bit of a comeback. There have
10 been a few cases.

11 Essentially for those of you not familiar with
12 it, it is a regulation geared at selective disclosure of
13 non-public information to deal with the concern among
14 investors that some companies are reaching out to
15 favored analysts, favored institutional investors, and
16 giving them a bit of a heads-up of some good news or bad
17 news that's not quite out there in the public eye yet.

18 And we continue to see cases. And there have
19 been a number of investigations in the last couple
20 years, some of which have resulted in enforcement
21 actions, where you do see senior executives, you see the
22 CFO going home on a Saturday after reading what the
23 analysts are saying and making one-on-one phone calls to
24 a few analysts to talk them down off their numbers. Some
25 pretty -- some pretty blatant abuses out there.

0141

1 I think when the regulation was first passed,
2 there were concerns that, well, what if -- what if
3 someone has body language during an earnings call and
4 everyone picks up on it, is that unfair?

5 If you look at the cases that have been
6 brought, it's not body language. There are,
7 unfortunately, some corporate executives who will go out
8 there to a hedge fund who has made some general advances
9 in the past and actually pick up the phone and call them
10 and say, you know, your numbers aren't quite right.

11 So the calls I think that we've made have
12 definitely been cases where people would agree has been
13 a violation of selective disclosure.

14 And then the last area that's of perennial
15 interest to us in Enforcement is insider trading. And a
16 lot of these cases are very high profile. The playing
17 field here has really changed in the last few years for
18 the SEC and certainly for the criminal authorities who
19 pay attention.

20 Historically, you'll see basically one-off
21 situations. An executive, a director, an employee who
22 learned something non-public about the company and trades
23 on it or tips.

24 What you've seen changing in the last couple
25 years are large-scale trading rings, systematic trading

0142

1 where you see networks of individuals who provide
2 information, say, to hedge funds reaching out to
3 employees of multiple public companies and
4 systematically obtain non-public information, allowing
5 investors to make millions of dollars.

6 These cases, you know, the repercussions are
7 huge. They have gotten much criminal interest. You
8 have wire taps involved, which really changed the degree
9 and nature of the investigation. Fascinating cases, and
10 not the sort of thing any public company wants to get
11 involved in.

12 Now, the repercussions tend to be for those
13 individuals who are trading and tipping, not necessarily
14 for the company itself. But again, there are huge
15 resource costs.

16 And if the SEC comes calling and next thing
17 you know you've got a senior executive or a member of
18 your board who's wrapped up in an SEC investigation,
19 that can have some serious implications for the future
20 of that individual at your company.

21 So it's definitely, again, worth -- you know,
22 I say it over and over, make sure you got the internal
23 controls in place. Make sure that any non-public
24 information is disseminated only to those who need to
25 know and at the last possible moment to reduce the risk

0143

1 of that leaking out.

2 The other piece of advice I have to give you,
3 especially if you are involved with a newly public
4 company, is the importance of a trading plan. There is
5 an SEC rule that provides for presumption, that if
6 somebody who is trading pursuant to a regular trading
7 plan is not trading on the basis of non-public
8 information.

9 So if your executives have received a large
10 amount of stock, which has value once the company goes
11 public, and get on a trading plan, so that the first day
12 after every earnings announcement every quarter, X
13 percent of the portfolio is liquidated, it makes it very
14 hard for us to get interested.

15 When we see that a CFO made a very large sale
16 the day before an announcement, we will make a phone
17 call and ask about that trade. If we get a copy of the
18 trading plan that says, well, we trade on that day of
19 that month every single month, and we've done that for
20 three years, that's probably the last you'll hear from
21 us.

22 So I can't emphasize about the importance of
23 having a trading plan. And following it. The trading
24 plan doesn't do much good if you don't follow it, or if
25 your trading plan is that I will trade a lot of stock

0144

1 the day after, the day before really good news and --
2 that's not going to work.

3 But if it's -- if it's a legitimate plan that
4 is followed that's objective and it really takes away
5 the element of trying to capitalize on nonpublic
6 information, it's an excellent idea.

7 And then, finally, I wanted to hit on two
8 issues that come up with companies that are not yet
9 public that tend to be repeat players in our office.

10 Private companies out there financing through
11 private offerings that are playing fast and loose with the facts.
You know, the number of fraud cases, it's an
13 ongoing area for our interest when you've got false
14 statements being made in connection with private
15 offerings.

16 Most importantly are representations about how
17 the money is going to be used, the proceeds are going to
18 be used, especially if the money is going into the
19 pockets of the individuals running the company. It very
20 quickly begins to look like misappropriation if there is
21 a disclosure about a certain compensation structure that
22 will be used, but most of the funds, the offering proceeds
23 are going into the pocket of the executives or they're
24 getting large loans that may never be repaid. So
25 representations about what is going to happen with the

0145

1 proceeds of the offering are going to get our attention.

2 We said we repeatedly see instances of playing
3 fast and loose with the background, whether educational,
4 employment background of the principals of the company.
5 Going to attend a seminar one day does not make you a
6 Harvard graduate.

7 You see, you know, overselling of the
8 prospects of the product or service that the company
9 sells; revenue projections that have absolutely no basis
10 in reality. Again, just because you're in telecom space
11 does not mean that you can have the same projections as
12 Apple does for the iPhone.

13 Similarly, talking about your business
14 prospect, your business partnerships has to be honest.
15 And again, you know, the fact that you carry an iPhone
16 does not mean that Apple is a strategic partner of your
17 company.

18 So the things that people will say are crazy.
19 And it's, again, not very difficult for us to disprove a
20 lot of the representations we see.

21 Yes, sir.

22 MR. WALSH: When you mentioned right before
23 about the private placement, do you find a lot of --
24 more issues with private placement than debt, issuing
25 debt as opposed to friends and family trying to raise

0146

1 some money (inaudible)?

2 MR. FAGEL: I would say that, you know,
3 frankly, where we most frequently see it are in equity
4 securities offerings by small companies, which sometimes

13 kind of activity with trading and you get a FINRA letter
14 that says, what do you know, and what was everybody
15 doing on March 6th? That kind of a letter.

16 How come you answer everything, and then you
17 don't get a response back? And you're supposed to
18 believe that if the file is sort of divisible by two,
19 it's over. Do you know what I mean? Or we don't get a
20 response back from the Exchange that says, oh, we're
21 okay with what y'all did on March 6th, and it's over. In
22 other words, you never seem to get case-closed letters.

23 MR. FAGEL: Yeah. No, I understand what
24 you're saying. There's a few different issues wrapped
25 up there.

0155

1 In terms of FINRA, you know, when there is an
2 insider trading issue, the exchanges are incredibly
3 sophisticated. So they've got bells and whistles that
4 go off anytime there's an announcement and significant
5 trading in the days leading up to that. So it would not
6 be unusual to get a letter from the exchange.

7 MR. JACOBS: Right.

8 MR. FAGEL: You know, NASDAQ will send a
9 letter saying, can you tell us who was involved in this
10 announcement? You know, I can't tell you what their
11 practice is and why they do or don't respond to what
12 happens afterwards to the extent that results in a
13 referral from the exchange to us, which is typically
14 what will happen.

15 If we begin investigating and talk to you, it is
16 the practice, standard practice of the Division of
17 Enforcement that we complete -- when we complete our
18 investigation, we send a closing letter. That should be
19 done as a matter of course.

20 It is the instruction to my staff that when we
21 are done, you send a closing letter and say, we're done,
22 and we're not making any recommendation to the
23 Commission that enforcement be brought.

24 MS. JACOBS: Is that unique to y'all out here?

25 MR. FAGEL: No. That is the policy of the

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1 Division of Enforcement.

2 There are exceptions. If there is, for
3 example, criminal interest or if there are different
4 matters that are related and we're concerned if we send
5 this closing letter to you and you make it public and it
6 creates perception, that everything has gone away.

7 So there's exceptions, but for the most part
8 that is the practice.

9 I do get this question periodically from
10 defense counsel who say, well, we haven't heard from
11 you. You can call. And, you know, I can't tell you how
12 many times I hear, well, I'm afraid if I call, I'll
13 remind you to take a look at this investigation.

14 My job is to manage what happens in my office.

15 We have multiple levels of management. I get -- have
16 quarterly calls with Rob Khuzami, the Director of
17 Enforcement in Washington, to go over our docket.

18 We haven't forgotten about the investigation.
19 You're not going to remind us, oh, yeah, that case, we
20 need to sue this company.

21 So it's not that hard to pick up and say --
22 and a lot of people do it, and say, you know, we haven't
23 heard from you in some time, what's going on? Sometimes
24 they'll say, you know, that slipped through the cracks,
25 we're done. Sometimes we'll say, it's still going on.

0157

1 Sometimes, look, you get a difficult matter
2 and it can take months and months for us to decide how
3 to resolve it, to work through the Divisions in D.C. We
4 can't bring any Enforcement action without the five
5 Commissioners in Washington signing off. That process
6 can take some time, especially for something that's
7 novel or controversial.

8 So sometimes the answer is, I can't tell you
9 what's going on, but I'll get back to you. But if it's
10 really we're done, we'll tell you. That is the policy.

11 In terms of a letter to Corporation Finance, I
12 can't -- I do not know what the process is for closing
13 those down.

14 MR. NALLEGARA: We do the same thing. Our
15 policy is to send a letter saying that we're done. And
16 if we don't, you should -- you should call Marc too.
17 I'm just kidding.

18 MS. GREENE: On a standard comment letter like
19 something on a question on filing, isn't there -- and we
20 haven't gotten one in a really long time, no big deal,
21 but I think it says, unless -- once you respond, unless
22 you hear from us, you assume --

23 MR. NALLEGARA: I think --

24 MS. GREENE: Is that old?

25 MR. NALLEGARA: Yeah, I think that's old.

0158

1 You shouldn't be getting that.

2 MS. GREENE: I don't know how long it's been.

3 MS. ZEPRALKA: We send a "no further comments" letter.

4 MR. FAGEL: Any other questions I can answer?

5 MR. DENNIS: What's your opinion of the crowd
6 funding?

7 MR. FAGEL: What's my opinion of the crowd
8 funding? Well, I leave it to the regulatory folks to
9 make those decisions. I only have to clean up the mess
10 when something goes awry.

11 Okay. I can't weigh in on that itself. What
12 I can tell you is the Enforcement staff here gets very
13 busy anytime it is easier for smaller entities and
14 individuals to raise money. And that's the way it
15 works. The more -- I do see that the regulatory
16 burdens, as expensive and onerous as they may sometimes

17 be, they minimize fraud. So it's a trade-off that the
18 industry has to make and that the regulators have to
19 make at what -- you know, what's the cost versus what's
20 the fraud prevention?

21 You know, any time that there is more ability
22 to, you know, widen the net of how many people can be
23 out there raising money for more people, I'm going to
24 get busy with fraud cases. And I can't tell you how
25 many operators are already out there using the word

0159

1 "crowdfunding" in their offerings of what are probably
2 outright frauds or Ponzi schemes.

3 So, you know, I think that there's some risk
4 in there. You know, does it help small businesses? You
5 know, that's not for me to say in the equation that I
6 get into, but there are trade-offs involved. And I
7 think it is important to recognize the trade-offs that
8 it is going to likely result in some problems.

9 MR. NALLENGARA: Thank you, Marc.

10 MR. FAGEL: Thank you.

11 MR. GRAHAM: So that gives us five minutes.

12 MR. NALLENGARA: Give people time to check
13 back home. Meet in ten -- no, no, five.

14 MR. GRAHAM: It's a negotiation. Okay. Ten
15 minutes.

16 (A brief recess was taken.)

17 MR. GRAHAM: Let's get back together with the
18 afternoon session. As you know, this afternoon we are
19 talking about the disclosure rules of smaller companies
20 and the issue of scaling. And we've put together a panel
21 for this afternoon to give us some background.

22 And their full biographies are in the
23 materials that you've received earlier. Let me just
24 kind of run down briefly who you will be hearing from.

25 First is Steve Bochner sitting next to Lona.

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1 He's a partner at Wilson Sonsini with more than 30 years
2 of experience practicing corporate and securities law.

3 From 2009 to 2012, Steve worked as the firm's
4 chief executive officer, and is currently a member of
5 its board of directors.

6 He also recently served on the IPO Task
7 Force, whose recommendations served as the basis for the
8 IPO-related provisions of the JOBS Act.

9 From 1996 to 2011, Steve served on the NASDAQ
10 Listing and Hearing Review Council, and he also served
11 on the California Department of Corporation and
12 Securities Regulation Advisory Committee.

13 Steve also -- Steve was also a member of the
14 SEC's previous Advisory Committee on Smaller Public
15 Companies that was formed in 2005.

16 Steve, welcome.

17 Jeff Schwartz is an associate who -- we kind
18 of skipped over you. I see "Bobby" in the notes. Do

19 you go by Bobby?

20 MR. BARTLETT: I have never been able to shake
21 it.

22 MR. GRAHAM: Well, we just skipped right over
23 you, Bobby.

24 And finishing up with Jeff Schwartz, he is an
25 Associate Professor at the University of Utah, S.J. --

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1 the S.J. Quinney College of Law. He teaches business
2 organizations and corporate finance, and his research
3 centers on securities law, investment-management
4 regulation, and retirement policy.

5 Prior to joining the faculty of University of
6 Utah, Jeff taught and practiced law in Southern
7 California.

8 In practice, he served both as in-house
9 counsel and as a corporate attorney for Munger Tolles
10 where he represented clients regarding mergers and
11 acquisitions, corporate governance matters, and
12 securities law compliance. So Jeff.

13 Now back to Bobby. Robert Bartlett is a
14 Professor of Law at Berkeley. His primary research --
15 his primary research interests focus on the intersection
16 of finance and business law, and he teaches in the areas
17 of securities regulation, corporate finance, and
18 contracts.

19 He also serves as a member of the faculty for
20 the Berkeley Center on Law, Business and the Economy.

21 So that's -- is that a journal?

22 MR. BARTLETT: No, it's a center at Berkeley.

23 MR. GRAHAM: Okay.

24 MR. BARTLETT: Actually, Steve's there as
25 well.

0162

1 (Outside noise.)

2 MR. GRAHAM: What is that noise?

3 Okay. Let's see. And you're an editor of
4 Berkeley's -- of Berkeley's VC Research Network.

5 Bobby previously worked as a corporate
6 associate at Gunderson.

7 So that is our expert panel, and looking
8 forward to hearing what you have to say about scaling,
9 if we can hear you through the scatter.

10 Who are we starting with?

11 MR. BOCHNER: Starting with me. Great to be
12 here. Sitting awfully tall. Unusual for me. So it's
13 really a pleasure, a privilege to be here today. It's
14 hard to believe that our -- I was on the SEC Advisory
15 Committee seven years ago. And Leroy was on that
16 committee, and there was another member who -- Richard
17 Brown, who's in the audience today. It was a great
18 experience. And many of our recommendations did
19 translate into -- directly and indirectly into real
20 (inaudible) form.

21 So we found that the staff took the
22 recommendations very seriously, and we felt like we made
23 an impact. So I encourage you to take advantage of this
24 opportunity.

25 Some of the things that we focused on in those
0163

1 days was -- SOX was pretty fresh, and so we spent an
2 inordinate amount of time on 404. And I think it had
3 some role, Leroy, in actually getting the auditing
4 standard changed. I think we can take some credit for
5 that.

6 Other things like integrating S-B into
7 Regulation S-K, which got rid of the stigma of using
8 small reporting rules and other types of scaled
9 disclosure.

10 So I think you can make a real impact.

11 And so some of the dialogue really hasn't
12 changed a lot from those days. But 404 just sucked all
13 of the oxygen out of the room. It seemed for most of
14 those sessions, we did spend a fair amount of time on
15 scaled disclosure. And obviously that continues to be an
16 issue, how to make the markets, how to make securities
17 regulation achieve that very delicate balance between
18 investor protection and capital raising.

19 So we struggled in those days to try to find
20 it. I'm sure you're struggling to try to find that
21 balance as well.

22 I'd like to start my remarks with making a
23 connection between the prior panel and the scaled
24 disclosure. I do think market structure is directly
25 related to the scaled disclosure issue. I'll talk a
0164

1 little bit more about that in a moment.

2 I think we're at a really important juncture
3 here, and I feel that even more so than what we've
4 learned since. And the reason I think we're at a unique
5 juncture, we have a confluence of changes in
6 technology, market pressures, foreign competition, all
7 kind of coming together and I think creating a cocktail
8 of, you know, whether you call it innovation or a
9 thought process, that's really challenging what has up
10 to now been a fairly rigid structure, you know, for 80
11 years since -- almost 80 years since the
12 Securities Act of 1933 was adopted that sort of envisioned
13 a two-tier world: a paper-based world of purely private
14 placements, you know, with some exception. And then
15 full-blown Sarbanes-Oxley, Dodd-Frank compliant world,
16 a public world.

17 And I think what you're seeing now is that
18 paradigm being challenged, being challenged for a number
19 of reasons. But one of those is that I think the
20 confluence of increased regulation, some of the trading
21 issues we've heard about this morning, and we're going to
22 hear about later on today. Investor expectations has

23 created what I call a gap in the capital market. I
24 think this gap is tangible. And you in fact have been
25 talking about it today. It's a gap that's characterized

0165

1 by how long it takes to get a company public.

2 In my world, which is kind of Silicon Valley
3 technology companies, you got a hundred million in
4 revenue now and have market caps that are approaching a
5 billion dollars. We really don't have a viable
6 chance -- absent some hyper-growth story perhaps, we
7 really don't have a viable chance of getting Goldman
8 Sachs, J.P. Morgan to get interested enough to expose
9 you as an IPO candidate to a client base and -- their
10 customer base.

11 This -- this gap that's developed between the
12 private finance world, the seed round, Series A, B, C,
13 D, and then going public, which used to occur over five years
14 and used to occur when companies noted a \$30 million
15 revenue range. If you go back and look at Cisco and
16 Apple and Microsoft's prospectus, they really could not
17 go public today because they just don't have the scale
18 to support the expense structure that frankly investors
19 would expect through a company.

20 And this gap -- some aspects of this gap I
21 think are good things. You know, I think to the extent
22 that we've improved investor protection with -- with
23 listing standards and regulation/government reform, some
24 of that is quite good for the retail investors I
25 suppose.

0166

1 But what it's done in that gap, that move from
2 five years to ten years, that move from 30 million in
3 revenue to a hundred million in revenue, that increased
4 expense structure to support a public company, is it's
5 created capital raising and liquidity challenges in the
6 end. And that's, I think, a lot of what we're talking
7 about and saying.

8 As we talk about market structure and talk
9 about scaling regulation, I think we're really zeroing
10 in on that gap. And that gap is important because it
11 turns then to foreign competitiveness, growth --
12 economic growth, job creation, and the like.

13 The '33 Act construct, as I mentioned a bit
14 ago, is looking increasingly out of date. You can
15 see -- you can see that out-of-date aspect to it, not
16 only in the size of the companies that are going public
17 today, but just in the use of technology.

18 The idea that -- that information outflows
19 instantaneously, versus 1933 when you actually had --
20 the rules were designed for paper-based, or paper changed
21 hands. Investors can get information instantly. The
22 idea that the prospectus was the sole disclosure
23 document created a regulatory environment around this
24 sort of sacrosanct piece of paper that we use to audit

25 or offer securities.

0167

1 Now that's coming under a lot of pressure as
2 investors are bombarded with all sorts of information,
3 and they can get it instantaneously.

4 Professor Schwartz, whose paper I read, I
5 think shares these observations about the outmoded
6 nature of our market structure. I think there's only
7 going to be increased pressure on our market structures
8 as the need for -- I don't think this gap is going to go
9 away. We may be able to ameliorate it with some reduced
10 disclosure and so on. But I think when the retail
11 investors dispose, I think it's going to be very hard to
12 submit and grow back a lot of reforms.

13 So what I'm intrigued about, is there -- is
14 this two-tiered market structure the best that we can
15 do? Is that construct from 1933 really the right
16 construct, or are some of these new models that we're
17 seeing fill this gap that I described, whether it's, you
18 know, the SecondMarket/Sharespost providing liquidity
19 or AngelList providing capital raising capabilities,
20 should that be the solution as opposed to sort of
21 arguing about when we roll back SOX, what's the level of
22 disclosure and so on? Can we be more innovative with
23 different types of market structures that I think are
24 very much in the vein of scaled disclosure? Scale
25 disclosure by sort of taking the public company world

0168

1 and trying to roll back disclosures based upon the size
2 of the company.

3 But that always presents a dilemma because
4 those are the -- the smaller companies are the riskiest
5 companies. So if you roll back disclosures -- and this
6 is some of the dialogue we had in our '05, '06 SEC
7 Advisory Committee -- roll back disclosures for those who
8 compromise investor protection, the risk is kind of
9 cumbersome. So that's the dilemma.

10 Whereas a market structure sort of solution
11 where you tier access to different markets based upon
12 the type of investor so that you -- investors that don't
13 need registration-level protection perhaps have access
14 to different kinds of markets maybe with different tick
15 sizes and some of the other innovations that all of you
16 are talking about, I think that's what -- that's what
17 intrigues me.

18 So I encourage you to think about scaled
19 disclosure and recommendations in both contexts, both --
20 you know, are there things -- is there low-hanging fruit
21 in terms of current securities regulatory environment
22 disclosure requirements and audit standards that really
23 are overkill and not necessary for investor protection,
24 kind of relook at that balancing between capital-raising
25 investor protection, but also take a look at whether the

0169

1 actual structure of our market, this two-tiered world,
2 this two-tiered regulatory environment, I might call it
3 with some license, because obviously there's SEC rules
4 that do different things. Reg A might be a good
5 example.

6 But by and large, that's kind of how -- you
7 know, that's how the world has worked. Private
8 placements, public offerings, those worlds have gotten
9 further apart, it's created this gap in the middle, all
10 this pressure. And I think that's a big reason why
11 you're here today.

12 Some of the changes that we need to bring
13 about these kinds of market structure innovations we
14 recommended in 2006. And some of them have been
15 addressed at the SEC Small Business Forum over the years
16 or in the report. I remember that; I presided over
17 that.

18 And some of them are -- have become law and
19 are about to become law under the JOBS Act. And
20 examples of that are Section 12(g) relief, the 500 shareholder
21 relief, facilitating new methods of solicitation using
22 modern technologies.

23 Knocking on doors on Sandhill Road is one way
24 to find investors, but we have -- if we can find
25 people spouses on the Internet, can't we hook up more

0170

1 efficiently investors and companies in some way that
2 doesn't compromise investor protection?

3 Professor Schwartz points out in his paper
4 additional solutions should be scaled. I mean, the size
5 of the issuer, the investor protection. And that
6 would -- I think that would not only help with capital
7 formation and job creation, but also help our foreign
8 competitiveness against markets, which still have yet, I
9 think, to be a real threat to our domestic markets here.

10 But I don't think that's going to last for a
11 decade or two decades. I think more markets are
12 going to compete for listings or certain listings,
13 companies in those areas. I think they've done that
14 successfully.

15 Where they have been less successful is
16 competing for listings with, you know, the mainstream
17 U.S. venture backed high profile issuer. We've managed to
18 hang on to those, but I don't think we can take that for
19 granted.

20 You know, I think, as is the case with other
21 industries, the U.S. should innovate their market
22 structure, the same way it is innovative with respect to
23 information technologies and life sciences.

24 So I've been pontificating a bit, but I do
25 have some specific recommendations about things that you

0171

1 can do.

2 Before I go to those, let me -- let me just

3 talk about an example of a new kind of market structure,
4 which is AngelList. And if you haven't seen AngelList,
5 it's an online marketplace where you have to get -- you
6 have to prove you're an accredited investor, and
7 companies can list matches, investors, and companies.

8 And we -- I think just a couple of days ago we
9 announced in conjunction with AngelList that we are --
10 that they put up a new portion of their website where
11 startups can go and basically close a financing on an
12 automated basis using documents online. And we -- and
13 we committed that for clients we then take on -- we'll
14 do that part of the closing process for free.

15 So you can see the, you know, the amazing
16 change over just a decade ago where you can go -- where
17 you go on a website, hopefully get access to investors
18 that are interested, have a term sheet negotiated, have
19 financing documents created. And basically lawyers who
20 author them still need to be involved in things like
21 disclosure schedules and organization and securities law
22 for clients. But the basic fundamentals of generating a
23 term sheet and generating a document and finding
24 investments are automated, and I think that's really
25 cool.

0172

1 And I think there is -- excuse me. I think
2 there's more of that to come. And I think SecondMarket
3 and Sharespost will reflect that innovation with respect
4 to liquidity.

5 Several years ago I gave a series of talks on
6 what kinds of regulatory changes would be necessary to
7 bring about innovation with respect to these alternative
8 markets. And I said there were four changes which need
9 to be made in order to have kind of this gap filled with
10 a different kind of market structure.

11 I said one was a change to the 500 shareholder
12 test. Because if you had a robust alternative market,
13 as soon as you got the 500 shareholder, you go public,
14 you know, nobody was going to do that. You weren't
15 going to have meaningful liquidity. So I said there
16 needed to be some relief to allow companies to be able
17 to operate in that segment without fear of having to
18 register.

19 I said secondly there needed to be some
20 changes to the general solicitation provisions to use
21 modern technologies and access a broader swath of
22 investors using technology.

23 Thirdly, I suggested that federal preemption
24 of Blue Sky laws was necessary because Blue Sky amounted
25 to a 50-state Blue Sky compliance check. And to do

0173

1 compliance work, using a private company is expensive
2 and burdensome.

3 And lastly, I said that you needed to provide
4 better liquidity through 144 amendment.

5 So I said, if you could imagine all those
6 things being done, you could envision a different kind
7 of -- kind of market structure, perhaps with different
8 governance standards and listing requirements that could
9 provide some amount of liquidity, some amount of capital
10 raising, and be accessible by investors, that, from a
11 regulatory point of view, whether it's accredited
12 investors or some higher standard, are investors that
13 are deemed not to need registration's
14 protection. So sort of a scaled market approach.

15 So interestingly, the first two have actually
16 been accomplished during the process being accomplished
17 by the JOBS Act. You have 12(g) relief under the JOBS
18 Act. And the SEC, as Lona indicated this morning, just
19 published a proposal regarding the general solicitation
20 provision. I'll comment on that in a moment.

21 I think that the two other changes are ones
22 that I hope you think about.

23 One is -- one is 144 change. And let me
24 explain it this way: Under Rule 506, if I'm an issuer,
25 I can sell stock to an accredited investor without

0174

1 registration. And let's say that investor is Sequoia
2 Capital, a well-known venture capital fund. Sequoia
3 Capital, though, if it wants to sell those shares and
4 rely on an SEC safe harbor, it has to have a one-year
5 holding period, even if it's selling those shares to
6 Kleiner Perkins. And the reason that that's an issue
7 is that creates stiction. If you imagine an efficient
8 middle market -- actually, it's stiction, which I
9 believe is unnecessary.

10 In other words, if an issuer can sell -- sell
11 to Sequoia without registration because Sequoia meets
12 whatever standards are put into place for investors who
13 don't need registration-level protection, why does
14 Sequoia have to endure a one-year holding period to sell
15 to another similarly situated investor? I would argue
16 you don't need that. There's no investor protection
17 mandate in that one-year holding period as long as the
18 transferee meets the same standards as are required when
19 that first investor parts with their money.

20 So I think what that would do -- there is a
21 "if we build it will they come" aspect to this. That
22 may be above my pay grade because it really relates to
23 our institutional investors in the market, you know. But
24 early indications if you look at AngelList are -- I
25 think are certainly intriguing in that regard.

0175

1 MR. WALSH: Do you know the rationale for that
2 decision years ago?

3 MR. BOCHNER: What's that?

4 MR. WALSH: The one-year hold.

5 MR. BOCHNER: Yeah, there's a good rationale
6 for it. And Lona can chime in here, too.

7 But the thinking is that if you have -- if you
8 go through -- from a regulatory point of view, if you
9 require a company to file a registration statement, you
10 know, that exposes retail investors. If you have a
11 private placement, you don't have to do that with
12 certain standards that you put in place like accredited
13 investors.

14 But yet, if accredited -- if you are an
15 issuer, I can sell to an accredited investor, and the
16 accredited investor can turn around and distribute the
17 shares publicly to a bunch of non-accredited investors
18 without registration, then that's just really an end-run
19 around the registration requirement.

20 So it was put in place for a good reason.
21 It's just that I think, you know, this -- you know, the
22 idea of this sort of secondary market, this middle
23 market was not really in existence then.

24 So I think we now need to expand that thinking
25 to say, well, trans -- we don't need a one-year holding

0176

1 period if the transferee meets whatever standards we set
2 for not needing registration level protection. So --

3 MS. SMITH: Steve, your standard of time that
4 they're warranting, you know, that there's a demand for
5 accredited investors wanting to pick up that
6 (inaudible).

7 MR. BOCHNER: Karen, well, you're -- given
8 your background, you probably have more expertise on
9 this than I do, but I think you suffered from the other
10 side of that in your prior role because I think
11 there's -- the answer is, from my experience, that
12 companies do want that, but they want to control it.
13 And so I think a lot of, what I know you had to deal
14 with in your prior life was sort of the bad side of
15 that, shares getting out, being out of control, worrying
16 about the 500 shareholder test, worrying about the
17 company liability.

18 So I think that the standards aren't in place
19 yet, but I think the issuers would like to facilitate
20 that liquidity, but control it.

21 MS. SMITH: Because the issue we had
22 (inaudible) --

23 MR. LAPORTE: Could you make sure to
24 speak into the microphone, please?

25 MS. SMITH: Sorry.

0177

1 I mean, I think we have the issue of the
2 example of Sequoia wanting to sell to Kleiner, it was
3 employee A wanting to sell shares to some random person
4 to offset the market. I guess I'm just curious
5 (inaudible).

6 MR. NALLEGARA: Yeah. It's a fair question
7 whether Sequoia can sell it through some trading
8 facility, not sell it through another private -- I mean,

9 their -- your question is whether they -- whether they
10 can freely trade the securities rather than rely on
11 other private placements to sell the securities. So,
12 you know, Kleiner -- Sequoia sells to Kleiner, the
13 problem is you couldn't sell it, you couldn't put it in
14 newspaper ads and sell the securities you bought.

15 MR. BOCHNER: Oh, correct, yeah.

16 MR. NALLENGARA: What you're suggesting is
17 someone taking advantage of some -- someone being able
18 to take advantage of AngelList or some list like that to
19 be able to sell the securities.

20 MR. BOCHNER: So if AngelList -- if AngelList,
21 not to pick on them. You imagine some market structure
22 that's a credible market structure, maybe it has
23 listing -- some listing standards, maybe some governance
24 standards, but well below the Sarbanes-Oxley, Dodd-Frank
25 level. It would be a place where you could go to raise

0178

1 capital, like AngelList is facilitating today. And
2 hopefully there is going to become a meaningful middle
3 market, would allow some -- some liquidity.

4 And if I were saying that there would be an
5 issuer control liquidity, I think the issuer should have
6 control have to (inaudible) to the board.

7 But to the extent that you had a one-year
8 holding period existing today, so you actually had to
9 buy it, that would create a lot of inefficiency. But
10 there's -- you know, there are other ways to trade
11 securities like the four one and a half exemption, but there's
12 sort of a race to the bottom.

13 You're smiling, because you're well aware of
14 that.

15 So we do need -- I think we do need either --
16 in order to -- if you like the idea of a different
17 market structure and you like the idea of having some
18 liquidity in that market structure, then a one-year
19 holding period doesn't make sense. As long as the buyer
20 of that is also on that -- on that marketplace that only
21 allows investors that don't need registration protection
22 and is done in a way that the issuer has decided to take
23 advantage of. So the issuer is always going to say, I'm
24 either going to list there, I'm not going to list there.
25 I'll allow my shares to be traded there.

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1 And certainly, as you point out, Karen, I
2 think a lot of the liquidity strains are coming from
3 employees who have worked for seven years and they want
4 to buy a house or they have other health needs or
5 whatever, and yet the company can't go public yet. It
6 doesn't meet this ever increasing threshold to go
7 public. I think a lot of stress and strain, frankly, I
8 think a lot of these business models are propped up to
9 deal with that.

10 And I think your prior employer is just sort

11 of one of the very early companies that started -- that
12 had gotten into -- that was kind of dealing with an
13 environment that was equipping it with all sorts of
14 issues. And some of these, like the shareholder test,
15 help ameliorate to some degree.

16 So I'll hurry up so I'm not taking too much
17 time away from these other presentations.

18 So the first of my recommendations are to
19 consider both whether the 144 one-year holding period
20 makes sense if the transferee meets certain standards.
21 And the second is federal preemption with respect to
22 that secondary transfer, some kind of a 50-state Blue
23 Sky.

24 Secondly, and this is a little long-term, I
25 think the 500 shareholder relief is welcome. There's

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1 one little tweak that I'm kind of unhappy with, which is
2 that while employees are excluded from the -- now the
3 2,000 shareholder count, accredited investors aren't.
4 And I would argue that if an accredited investor can buy
5 shares from an issuer without registration, why should
6 just a sheer number of them give rise to the need for
7 registration under the '34 Act?

8 So I think in addition to employees being
9 excluded from the account -- 2,000 shareholder count,
10 which they are now under the JOBS Act, in theory, that
11 the protections aren't needed because these are
12 compensatory transactions, not capital raising
13 transactions. I think the same theory should apply to
14 investors that are determined under other SEC rules not
15 to meet registration-level protection. So just
16 adding -- adding the numbers shouldn't give rise to
17 that.

18 So my second recommendation, and I think this
19 is longer term, but would be to exclude accredited
20 investors from the count.

21 You know, I have a third recommendation, which
22 is not really in the scaled disclosure area, but it
23 relates to Rule 506. Lona heard me make it on a webcast
24 the other day. But I think the SEC's proposed rule
25 under the general solicitation provisions is too broad.

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1 I was -- as Steve mentioned, I was a member of the IPO
2 Task Force that helped come up with some of the ideas
3 behind the JOBS Act, and general solicitation was one of
4 them.

5 But I certainly don't want to see late night
6 TV ads, newspaper ads, Internet, you know, commercials,
7 you know, blasting, hawking stock. I think that's bad for
8 the markets. I think it's bad from a regulatory point
9 of view. And I think it's bad for the kind of reforms
10 we're talking about here.

11 And it -- you know, the question is whether
12 the SEC has the authority under the JOBS Act to

13 constrain that. I actually think they do. I think
14 it's -- I think even though the bill says eliminate the
15 general solicitation provisions, I don't think that
16 means that the SEC can't regulate as to how that
17 solicitation occurs. And I think the SEC's experts in
18 these areas will have to decide whether or not I'm right
19 about that.

20 But I think SEC rules like 134 and 135 provide
21 a really good template for when the retail investor is
22 exposed, you know, how a company should be permitted to
23 offer stock in newspapers and TV and ads. That's my
24 third recommendation.,

25 My fourth does finally -- I should get to scaled

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1 disclosure. We took a hard look at this. We -- in '05
2 and '06 -- we suggested that many of the small business
3 reforms get made accessible to a broad swath of smaller
4 public companies. And these are things like a reduced
5 business section, reduced MD&A, reduced market risk
6 disclosure, reduced executive compensation provisions.
7 Some of these are addressed in the JOBS Act.

8 I would encourage you to look at the
9 threshold, to read it, that was established as a result
10 of our work in those days, which is a smaller reporting
11 company, \$75 million in market cap, which is not very
12 meaningful. You get a company public with that kind of
13 market cap and ask yourselves whether that threshold
14 ought to be raised with some meaningful number.

15 You know, back in '06 we were -- I haven't
16 updated this, but I think we were given the information
17 by the SEC Office of Economic Analysis, which said that
18 companies above \$787 million in market capitalization
19 represented basically 94 percent of U.S. market
20 capitalization, meaning that companies below that market
21 cap are very unlikely to result in systemic risk. You
22 know, you're just not having that much of a market cap
23 affected.

24 And you kind of use that as a theory to say,
25 well, if that's the case, there's no real systemic risk,

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1 which is sort of -- those were in those days
2 Sarbanes-Oxley and Dodd-Frank, let's see if we can't do
3 some things to make the disclosure burdens lessen. So
4 take a look at the scaled disclosure, the size, and see
5 if there's other low-hanging fruit out there.

6 And then I have one more recommendation. And
7 I have a prop for this recommendation, actually, that
8 Lona took a peek at.

9 This is my prop. And this is -- this is -- I
10 had printed out a client's filings.

11 Anybody guess how many years of SEC filings
12 this is for my client?

13 PARTICIPANT: One.

14 MR. BOCHNER: One year. And this is a --

15 there's a proxy statement, 10-Qs, and one 10-K. And
16 back in '05, '06 we actually recommended that EDGAR be
17 reformed and looked at.

18 EDGAR, you know, is a -- if you go on EDGAR
19 today, what you get is sort of a chronological listing
20 of filings. So 10-Q, 10-K, bunch of forms, proxy, 8-K.

21 And it's very hard to find stuff. You know,
22 where's the current business section, where is -- I
23 mean, I couldn't -- if you ask me, and I kind of read
24 this stuff for a living, tell me what the CEO made last
25 year, I can sort of find it, but it would take me a

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1 while. I have to know what document to go in.

2 And there's a lot of repetition in here.

3 There are financial statement footnotes that repeat over
4 and over and over. And it takes a lot of work, lawyers
5 reviewing it, accountants reviewing it.

6 And I would argue that, even if this is
7 written in plain English, this really isn't plain
8 English. When something gets this big, it's not plain
9 English. It's just hard to find.

10 So I think that -- there was an SEC initiative
11 many years ago called the 21st Century Disclosure
12 Initiative. I think it generated some ridicule to call it
13 that. But I actually think it proposed a really
14 interesting idea, which is to sort of do away with the
15 idea of the serial chronological list of filings.

16 And when a company goes public, they file a
17 company registration. That's their document. That's a
18 disclosure document. And every time a quarter occurs or
19 year occurs, you update that document, and you can see
20 where it got updated. So there's one static document.
21 As the business section, as the current comp, you can go
22 back and I think with technology figure out what the
23 company -- what changes had gotten made. But basically
24 there's one place to look.

25 And I think it would make -- I think it would

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1 reduce costs, and I think it would make the ability of
2 investors to ferret out information much, much better
3 and can actually help the rest of us.

4 So, again, thanks for having me here today,
5 and I really look forward to reading your
6 recommendations.

7 MR. GRAHAM: Thank you, Steve.

8 Who's next? Let's go. We think it's you,
9 Jeff.

10 MR. SCHWARTZ: Okay. So, first of all, thank
11 you very much for inviting me to share my thoughts
12 today. I think, Bob -- Mr. Bochner --

13 (Outside noise.)

14 I think I'll wait.

15 (Pause.)

16 Okay. So thanks a lot for having me. I'm

17 very excited to share my thoughts with you all. I've
18 been following the committee closely from afar. I
19 watched the webcast of the last meeting, so it's a
20 little surreal. I actually recognize all of you, but
21 you don't recognize me. And that's all a little
22 surreal.

23 Anyway, so in preparing my comments for today,
24 what I tried to do is to make them as relevant as
25 possible for the Committee at this point in time as you

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1 all seek to improve market conditions for small and
2 emerging companies.

3 To that end, what I thought I would do was
4 first briefly assess the helpfulness of scaled disclosure
5 and other current efforts to provide regulatory relief
6 to small and emerging companies. I plan to focus on the
7 smaller reporting company or SRC rules that were adopted
8 a few years ago, and then talk a little bit about the
9 JOBS Act, which, of course, was adopted earlier this
10 year.

11 Second, I'll offer my thoughts on what might
12 be advisable next steps to build upon those recent
13 reform efforts. I'll offer suggestions about how to
14 identify candidates for reform, and I'll give a few
15 suggestions of my own.

16 And then finally, I'll discuss if -- rather
17 than having small and emerging companies trade alongside
18 large established ones in the same market as we do
19 today, it might be better for these firms to have their
20 own market, with each of these markets set up with
21 specifically designed regulatory frameworks. I think
22 that builds a lot on what Mr. Bochner was saying
23 earlier.

24 So, first, turning to the Smaller Reporting
25 Company rules, the SRC rules essentially provide for

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1 scaled disclosure for companies with a public float of
2 under \$75 million. As was already brought up, what this
3 allows for, is it allows these companies to provide
4 fewer years of financial statements and less information
5 about their businesses and about their finances.

6 And while this seems like a nice change,
7 what's important to note about the SRC rules is that, in
8 substance, they're based upon around and largely a
9 continuation of the Small Business Issuer rules, which
10 has -- which had existed since 1992 throughout the
11 period of IPO decline.

12 What happened was that when the SRC rules were
13 put in place, the SEC essentially merged Regulation S-B
14 into Regulation S-K. And while this certainly cleaned
15 up the statute a lot, the adoption of these new rules
16 didn't do anything to offer any additional regulatory
17 relief to these small and emerging companies.

18 What the new rules did do, however, was

19 broaden access to scaled disclosure. Under Regulation
20 S-B, in order to qualify as a small business and to
21 receive scaled disclosures, you had to have under \$25
22 million in revenues and a public float of under \$25
23 million. Whereas, as I already alluded to, in order to
24 qualify for special treatment as an SRC, you can have up
25 to three times that amount in public float.

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1 So the rules did make a substantive change
2 here, in that, while they didn't actually provide for
3 more regulatory relief, at least they brought in the
4 number of firms that would be able to take advantage of
5 it.

6 But, as was already pointed out, \$75 million
7 is a very small number. So it only extends the
8 regulatory relief to the smallest of the public
9 companies.

10 And while it's difficult to make too much of
11 this, the adoption of the SRC rules didn't seem to move
12 the needle much in terms of IPOs. In other words, the
13 IPOs continued to decline after the SRC rules were put
14 in place, which at least suggests that it didn't do much
15 to make the public market that much more attractive to
16 emerging companies.

17 So my bottom line for the SRC rules is that,
18 while their heart is in the right place with scaled
19 disclosure, the regulatory relief that the rules provide
20 was likely too modest to do much good for any companies
21 that we're concerned about.

22 The JOBS Act, though, can be seen as an
23 attempt to offer further assistance. And in contrast to
24 the SRC rules, the JOBS Act did make a lot of changes.
25 But I'm not that optimistic that the JOBS Act will do

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1 that much to improve matters either.

2 So one thing that the JOBS Act does is that it
3 focuses on emerging firms to the exclusion of small
4 ones. So small companies that went public prior to the
5 JOBS Act got no additional regulatory relief under the
6 statute. And similarly, those companies that do go
7 public under the JOBS Act lose the protection of the
8 statute after five years.

9 Another concern I have is that, even what the
10 JOBS Act does attract -- so what the JOBS Act does do is
11 it provides regulatory relief for emerging firms, I'm
12 afraid that the regulatory relief it provides for
13 emerging firms doesn't do enough to make the public
14 markets more attractive for them either.

15 What the JOBS Act does, among other things, is
16 that it eases the rules on providing research reports
17 regarding emerging companies, both before, during, and
18 after the IPO process, and it also adopts some scaled
19 disclosure. But the scaled disclosure that the JOBS Act
20 provides for is rather modest.

21 And with respect to the provision of research
22 reports, there's been some rumblings that investment
23 banks and analysts are taking a wait-and-see approach
24 before taking advantage of the regulatory flexibility
25 that the statute provides for. So I'm not confident

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1 that those JOBS Act reforms will lead to that many more
2 public companies.

3 And finally, one particular worry I have about
4 the JOBS Act is how the on-ramp provisions of the Act,
5 which are designed to make going public more attractive,
6 interact with the changes to Section 12(g), which, by
7 raising the shareholder thresholds which trigger public
8 reporting, makes it easier for companies to remain
9 private.

10 What I'm concerned about is that because of
11 the changes to Section 12(g), more companies are going
12 to opt to remain private, and that this undermines the
13 goal of the on-ramp provisions and also can contribute
14 to the further erosion of our public equity market.

15 While this might be defensible, while having
16 firms stay private might be a defensible outcome, it
17 might be a defensible outcome if we thought that the
18 private markets had something to offer these small and
19 emerging companies. If we thought the private markets
20 offered a viable alternative to small and emerging
21 firms, we might not be bothered by the fact that more
22 companies are opting to stay private.

23 But my own view is that the private markets
24 don't offer a viable alternative and that the lack of
25 regulatory structure that supports liquidity and

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1 investor protection, and I think they raise various
2 concerns to the extent that participation is limited to
3 QIBS and accredited investors to the exclusion of
4 everyone else.

5 The way I view the equity markets overall is
6 that there is a -- is that there is in fact -- no, let
7 me say it again.

8 The way I view the equity markets overall is
9 that even though we have scaling in the SRC rules and
10 through the JOBS Act, that even though we have this,
11 there is this vast gulf between the highly regulated
12 public stock markets and the lightly regulated private
13 markets, and that neither of these alternatives is
14 attractive to emerging companies. So it very much
15 builds on what Mr. Bochner was saying.

16 And I think in light of this vast gulf,
17 perhaps what is missing is an intermediate regulatory
18 framework. And the way I picture this framework is as
19 having many of the hallmarks of the public securities
20 regulation, but at the same time containing
21 significant-enough cuts to regulation to have a material
22 impact on the amount that the firms we're concerned

23 about actually spend on compliance.

24 Now, I'm under no illusion that regulatory
25 change would be a silver bullet. As the Committee has

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1 discussed, there are a number of reasons that explain
2 the decline in a small company market over time. But I
3 don't think that's a reason not to make regulatory
4 changes. I think that if we put our efforts into
5 designing an efficient regulatory structure, it would
6 help matters.

7 One way to go about this, one way to create
8 this improved intermediate regulatory structure would be
9 to broaden and deepen the scaling of regulations that
10 already exist under the current rules.

11 So first, looking at the broadening as already
12 noted, the SRC rules, special treatment under the SRC
13 rules is limited to companies under \$75 million in
14 public equity outstanding. But there are far more
15 companies out there that could likely benefit from
16 regulatory relief.

17 In fact, maybe we should be looking at this
18 from a different perspective. Maybe instead of only
19 providing regulatory relief to the smallest public
20 companies, perhaps everyone should get regulatory
21 relief. Everyone, that is, except for the largest
22 public firms.

23 Several academics have pointed out that the
24 regulations that have been added on in recent years have
25 had the largest public companies in mind. They've been

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1 targeted at their misdeeds. And there's really been an
2 effort to hold these firms accountable for their
3 actions. And that, really, small and emerging companies
4 have just been caught up in the net.

5 If we look at the world this way, you can
6 picture a structure, a regulatory structure where the
7 largest public companies, the corporate high -- the S&P
8 500 type firms that make up the large percentage of the
9 market capitalization, that these companies are subject
10 to the highest regulatory scrutiny, but that small,
11 midsized, and emerging firms are subject to an
12 intermediate level of security.

13 So only the highest, only the largest firms
14 would have this highest level of scrutiny. Everyone
15 else would be subject to a subset under those
16 requirements.

17 Okay. But what should those -- what should
18 that subset be? So it's easy to say we should have an
19 intermediate regulatory structure, but, of course, it's
20 very difficult to actually come up with one.

21 In theory, regulation should decrease a firm's
22 cost of capital, right, as investors feel less of a need
23 to discount a firm's shares to account for fraud and
24 incomplete information. This means that in cutting

25 regulation, we raise the risk of actually raising a

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1 firm's cost of capital. And if we raise a firm's cost
2 of capital by more than we lower its compliance cost,
3 then we've actually done damage to the very firms that
4 we're trying to help.

5 If we look at the world this way, then what it
6 turns out we have to do is that we have to focus our
7 efforts on finding those regulations that cost the most
8 in terms of compliance, yet deliver the least in terms
9 of benefits, deliver the least in terms of investor
10 protection.

11 While this also is hard to do in practice,
12 here's a list of some candidates at least to think
13 about, some candidates for further discussion, for
14 further investigation.

15 So up here, as you look at the regulation
16 category, we have the usual suspects, I guess, of
17 Sarbanes-Oxley and Dodd-Frank. Smaller reporting
18 companies already get relief from Section 404(b) of
19 Sarbanes-Oxley, but perhaps they could also get relief
20 from 404(a), if not more.

21 Under Dodd-Frank, smaller reporting companies have a
22 temporary exemption from the Say-on-Pay rules, but
23 perhaps they could be exempt from a lot more of that Act
24 as well.

25 The Committee can also look at the MD&A, the

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1 Executive Compensation section of the Exchange Act
2 reports of these companies. There's already some scaled
3 disclosure for smaller reporting companies when it comes
4 to those areas, but perhaps these could be extended upon
5 as well.

6 But I don't think the committee needs to stop
7 and just look at how to scale regulation. I think there
8 are other areas where reforms could help lower costs as
9 well.

10 So if we look at the middle category, we have
11 the litigation environment. Perhaps steps can be taken
12 to make the litigation environment a bit less costly as
13 well.

14 One area that the committee could look at is
15 Rule 10(b)(5), at least as it pertains to secondary
16 market transactions. So let me flesh that out a little
17 bit.

18 So Rule 10b-5 is a foundational provision,
19 but legal academics have actually long questioned the
20 usefulness of 10b-5 damage awards against companies
21 for fraud in connection with secondary market
22 transactions in which the company played no role.

24 In these secondary market transactions, in
25 this context, where the issuer was not involved with the

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1 transaction, these damage awards tend to lack a term

2 function because the officers and directors who were
3 involved with the fraud are rarely personally liable
4 because they will be indemnified or insured. And these
5 awards also lack a compensation value as well because
6 what ends up happening is that these damage awards are
7 both paid by and paid to diversified shareholders. So
8 in the aggregate, what ends up happening is shareholders
9 end up paying themselves, minus a sizeable chunk for
10 attorneys.

11 So in light of this -- in light of the
12 circularity of 10b-5 damage awards in this context,
13 some academics have recommended a cap on 10b-5 damage
14 awards. Perhaps if we can -- if all companies are in
15 this cap, it can be something that can be applied to
16 small and emerging firms.

17 I also have up there Section 11 liability.
18 Section 11 is a provision of the securities laws that
19 allows shareholders to sue based on material
20 misstatements in registration statements. But the
21 shareholders do not need to show causation or (inaudible).

22 This heightened standard -- or I should say
23 this lowered standard in order to recover, this does
24 serve an investor protection function; that is, it provides
25 more protection for investors when they can sue without
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1 having as many elements to show.

2 But there are some folks out there who also
3 think that the risk of Section 11 -- the risk of Section
4 11 liability is deterring companies from going public
5 and also leading to overly costly and perhaps
6 duplicative due diligence efforts in order for companies
7 who are -- the companies are taking in order to -- in
8 order to avoid being sued.

9 So in light of the expenses that arise with
10 Section 11, perhaps Congress could amend the section, so
11 that rather than providing that shareholders can sue
12 based upon it, perhaps it can only be the SEC.

13 Finally, the other category I have up there is
14 listing standards. Today, among other things, New York
15 Stock Exchange, NASDAQ rules require that all the
16 companies have a majority independent board. And while
17 this also may serve an investor protection function,
18 it's actually empirically and theoretically contested
19 exactly how much investor protection good independent
20 directors do. And it turns out that independent
21 directors are particularly costly for small and emerging
22 companies.

23 So perhaps some thought can be given to using
24 these rules for small and emerging firms and simply
25 having these companies report on the extent to which
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1 their directors are independent. And this is already
2 required that they report on this, and perhaps that rule
3 would just be in case, and be the sole rule, that relates

4 to director independence.

5 MR. WALSH: Can I ask a question? What do you
6 mean the more expensive independent director?

7 MR. SCHWARTZ: So there's a study -- so
8 independent directors are just expensive because you
9 have to pay them, right? And it just -- it eats up a
10 greater percentage of the revenue of smaller firms to
11 pay these independent directors.

12 So there's been interesting studies out there
13 that show how much per dollar of revenue smaller
14 companies are paying on independent directors after
15 Sarbanes-Oxley, after these listing standards were put
16 in place, and it's a very high percentage, much higher
17 than it is for larger companies.

18 Does that answer your question?

19 MR. WALSH: Mm-hmm.

20 MR. SCHWARTZ: Great.

21 Okay. So those are my candidates for reform.
22 I offer these as food for thought. But I also think it
23 would be greatly helpful for the Committee, as part of
24 its ongoing efforts, to dive deeper into the costs and
25 benefits of securities regulation as it pertains to the
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1 companies that we're concerned about.

2 To add rigor to the difficult exercise of
3 recommending exact reforms to the SEC and Congress, I
4 think it would be helpful to do a couple of additional
5 things.

6 So one of which would be for the Committee to
7 either review or commission a review of the recent
8 empirical scholarship as it pertains to the cost and
9 benefits of securities regulation in this area. And
10 beyond that, the Committee could even undertake or
11 commission someone else to undertake its own study, a
12 study where it directly looks at the cost and benefits
13 of regulation in this area.

14 On the cost side, there can be a survey of
15 listed firms, preferably firms that are emerging
16 companies or smaller ones, to get a sense of what they
17 view as the most expensive and intrusive provisions. But
18 the cost is only one side of the equation, and likely
19 the easier side to measure.

20 It would also be beneficial for the Committee
21 to survey those who had input on the benefit side of the
22 securities laws. So to that end, there could be a
23 survey of sophisticated investors. Ask sophisticated
24 investors what they look at when valuing securities. If
25 they don't think something is important when valuing
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1 securities, likely it doesn't have that big of an
2 investor protection benefit. Because if it has an investor
3 protection benefit, that should be reflected in the price.
4 And these are the people who drive the prices.

5 So like I said, I think what I mentioned are

6 good areas to start looking, but I think digging deeper
7 into the cost and benefits through your own study or by
8 reviewing the empirical scholarship that already exists
9 would also prove helpful.

10 Okay. Finally, to transition just a little
11 bit abruptly into my final point, today, as we see on
12 the right side of the slide, we have emerging growth
13 companies and smaller reporting companies trading
14 alongside larger firms in the broader public market.

15 Because of this, the special regulatory
16 treatment to which SRC and emerging growth companies are
17 entitled under the JOBS Act and under the SRC rules,
18 because these firms trade alongside larger companies in
19 the broader market, this special regulatory treatment is
20 embedded within and, to the untrained eye, hidden within
21 the broader public markets.

22 If we simply continued to broaden and deepen
23 the regulatory relief provided under the JOBS Act and
24 the SRC rules, what we would also do is continue with
25 this construct, this construct where you have firms of

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1 various shapes and sizes all trading together, but all
2 subject to their own specific regulations.

3 But I'm not sure this is the best approach.
4 Instead, maybe it's better to separate things out, to
5 have firms -- to have different types of firms trade on
6 different markets, and to have these markets set up so
7 that they have regulations and a market structure that
8 actually fits these firms. And that's what we see on
9 the left side of the slide.

10 In my article that was included in the
11 background materials, I argue that we should have
12 separate markets for firms at different stages of their
13 lifecycle. So we would have a market for emerging
14 companies and a market for midsize and smaller
15 companies. And these markets could be subject to an
16 intermediate regulatory structure.

17 We would also have a market for large
18 companies. And this market for large companies would be
19 subject to the highest level of regulatory scrutiny.

20 And I offer this suggestion because I think
21 there are several benefits to separating different firms
22 out into different markets that are narrowly tailored to
23 fit those firms.

24 One advantage is that if we were to separate
25 things out in this way, we would have regulatory

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1 consistency within each market. All of the firms in the
2 market would be regulated similarly. This would mean
3 that they would be easily comparable, which would
4 increase efficiency on the market. Also, if we
5 separated things out in this way, there would be less of
6 a potential for investor confusion.

7 So, for example, let's say that Congress or

8 the SEC did choose to put a cap on its 10b-5 damage
9 awards for smaller companies. If this happened and if
10 these companies continued to trade alongside larger ones
11 in the broader public market, retail investors might not
12 realize that these smaller companies have this
13 limitation on litigation recovery. If, however, we had
14 smaller and emerging firms trade on their own markets,
15 we could make this limitation much clearer.

16 Another benefit of separating firms out into
17 different markets is that you could structure the market
18 itself to fit the firms that trade their own. So as
19 this Committee has discussed at length, smaller
20 companies face concerns regarding liquidity, and the SEC
21 or Congress may want to tackle those concerns by
22 allowing firms to choose their tick size or allowing
23 them to pay for liquidity or through some other avenue.

24 If regulators want to take that approach, I
25 think it would be much cleaner and much easier to do, if
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1 these firms actually traded on their own markets.

2 If instead you apply these tick size rules or
3 other liquidity rules to these firms in this broader
4 public market, I think it might be confusing, and it
5 might just be difficult to do, and clearer if they were
6 all separated out.

7 Like, it would -- for example, it would be
8 much easier if the midsize and smaller company market
9 had one tick size, and the large company market had
10 another. Or a small company market, you had a regime
11 where you could pick your tick size, whereas the large
12 company market you did not, something along those lines.

13 Finally, the last benefit is that today when
14 firms go public, they do so amidst a great deal of
15 regulatory uncertainty. A firm goes public under one
16 regulatory regime, but in a few years, there's a good
17 chance that the regulations that they will be subject to
18 will be much more demanding and expensive. And this has
19 to cause entrepreneurs to think twice about going public
20 at all, and must be doubly frustrating for emerging and
21 small companies who tend to get swept up in these
22 regulations that were meant to combat the misdeeds of
23 others.

24 I think if we separated these firms out into
25 different markets, it would be much more -- it would be
0204

1 much less likely that smaller and emerging companies
2 would be swept up in these reforms that were meant for
3 other types of companies. It would be much easier for
4 regulators to target reforms at the appropriate firms
5 and at the appropriate markets if different types of
6 firms were separated out into markets meant for them.

7 And I think if regulations in the future were
8 more well targeted at the appropriate group, it would
9 be -- it would be both fair and more efficient.

10 So although I think moving to a model where
11 you have different markets subject to different
12 regulations is different than the current scaling
13 approach that we've taken under the JOBS Act and the SRC
14 rules, I think it does offer some benefits and is,
15 therefore, a concept at least that's worth considering.

16 Thank you. I hope this helped.

17 MR. GRAHAM: I'm -- personally, I'm attracted
18 to that concept. I think the whole notion of having at
19 least two markets, or, you know, seeing some sort of
20 system so that you can be more targeted with respect to
21 the approach that you're taking with respect to each of
22 those markets, based on who's participating.

23 Have you given much thought to the feasibility
24 of actually implementing such a system?

25 MR. SCHWARTZ: A page worth in my article, out
0205

1 of 80. So I've thought about it. I have thought about
2 it a little bit, and I don't think it would be terribly
3 difficult.

4 So you already have the stock exchange. The
5 exchange is somewhat set up to have different markets.
6 So NASDAQ, for instance, has its BX Venture Market. You
7 could envision setting -- so today the BX Venture Market
8 has rules that are a little bit lesser than, but very
9 similar to the rules that govern the New York Stock
10 Exchange, more generally. You could picture that NASDAQ
11 venture market being governed by a different regulatory
12 template that is more intermediate in nature than it is
13 today, where it's just a slight tick below the New York
14 Stock Exchange.

15 So you could picture -- you could picture
16 markets adjusting -- you could picture the SEC working
17 with FINRA and the stock markets to actually change
18 regulations to fit existing -- to fit at least what
19 NASDAQ started to do.

20 So I don't think implementation would be easy,
21 but I don't think it's impossible either. It's just a
22 matter of changing listing standards and changing
23 regulations and having FINRA and the SEC and Congress
24 work together to do that.

25 (Talking simultaneously.)

0206

1 MR. GRAHAM: Go ahead.

2 MR. DENNIS: Oh, I was going to say, one,
3 we've got a market study for this. And kind of with
4 what Steven and I addressed on the previous Committee we
5 had, the big issue you've got to deal with is
6 perceptions because investors and companies are probably
7 going to view the emerging company market in your
8 example here as substandard compared to the large
9 company market. And so you, you know, you have to get
10 back by that psychological disadvantage. To me, the
11 regulations part, that's the easy part.

12 MR. GRAHAM: I don't think you have to do
13 that, though, because it says -- going back to the gap
14 that Steve was describing, you got your private
15 companies with a different set of rules, you got your
16 public companies with a different set of rules. There's
17 no particular stigma necessarily attached to being a
18 private company versus a public company.

19 But you do have this gap that is drawn between
20 those two segments. And if you just fill the gaps so
21 you have a natural progression, now I'm thinking
22 necessarily, you know, arrive at a situation where there
23 is going to be stigma attached to being in -- kind of
24 the first market that you hit to -- that you hit as your
25 company is evolving.

0207

1 You know, simply put, you have private
2 companies, then you have a market that is only for
3 accredited investors. Then as companies grow, you got
4 basically what we have now.

5 So it seems -- seems more like there's a way
6 of doing it without kind of stigmatizing the
7 participants the way, you know, Regulation S-B stigmatized
8 companies.

9 MR. DENNIS: I think -- I think that's the
10 biggest issue, is how do you -- I think like putting the
11 regulations together and how you logistically transition
12 is -- we can do that. I think the question is, will
13 people want to automatic -- the Facebooks of the world
14 are going to automatically want to jump to the highest
15 one and --

16 MR. GRAHAM: That's good. They're -- you're
17 up to, you know, the Facebook stage, they have plenty of
18 resources in terms of compliance, etc. So, you know --
19 so imposing on companies of that magnitude the
20 requirement that they go through the effort to provide
21 the level of extra protection that -- with registration
22 statement-type protection is not going to -- it's not
23 going to be an issue for them because, again, they will
24 have the resources. So --

25 MR. BOCHNER: I guess the -- kind of

0208

1 reconciling what Professor Schwartz talked about and
2 what I talked about. I think the big difference, we
3 kind of came at the same problem at a slightly different
4 angle.

5 I think what I was envisioning was addressing
6 that market, that -- those reduced requirements, and
7 justifying that from an investor protection standpoint
8 by limiting access to investors that are deemed not to
9 need that greater protection.

10 And I think Professor Schwartz was sort of on
11 that same theme, but saying, well, let's -- let's do
12 that gradation by sort of size of company. And, you
13 know, then the question is -- you know, they're both

14 sort of the same ideas coming at it from a slightly
15 different angle.

16 But the concern I had was whether -- I think
17 yours is a bigger idea. I worry that it's more wood to
18 chop in the sense that you're exposing the -- you know,
19 you're exposing the non-accredited retail investor. I
20 guess it's a question, really.

21 As you envision sort of that lowest end
22 market, would you limit access to that market kind of
23 the way I've envisioned in my -- in my world, or would
24 you let any investor access all those markets, and they
25 just sort of buyer beware based on the gradations of

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1 listing standards and compliance?

2 MR. SCHWARTZ: I've thought about that a lot,
3 and I don't have any good evidence to support this view.
4 But my bias tends to be in favor of letting everyone
5 participate. I don't -- it bothers me to have markets
6 that are restricted to -- that have special access
7 privileges. I worry that retail investors aren't going
8 to have access to the best companies if that happens. I
9 maybe have this kind of bucolic attachment to public
10 markets where everyone can participate.

11 So I am in favor of letting everyone
12 participate and putting warning stickers on the market
13 so that people can choose whether they want to be
14 exposed to those risks.

15 And the other, I guess, more practical concern
16 I have with limiting access to this intermediate type of
17 regulatory structure would be I worry about liquidity
18 and that whether there would be enough interest among
19 accredited investors and institutional investors to
20 support that market. And if we have retail investors, I
21 think there is a better chance that we would have
22 liquidity. So I think there's a trade-off between
23 liquidity and investor protection, and I guess I kind of
24 err on the side of liquidity.

25 MR. BORER: Isn't there sort of an analogous

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1 situation right now with the OTC market where they have
2 this -- Cromwell Coulson runs this exchange. It used to
3 be the Pinks; they changed the name because I guess it's
4 a derogatory name -- where companies can list without
5 being fully reporting, whether it's a foreign company
6 that lists here without becoming SEC filers.

7 And they have, I think, three different tiers.
8 One at the bottom, which is somebody can trade a stock
9 with no reporting at all, there's no voluntary
10 disclosure through OTC market, and there's skull and
11 crossbones next to the name, all the way up to the ones
12 who may trade there and be fully reporting, SEC
13 compliant, etc. There's an intermediate level of
14 disclosure, whether it is voluntary reporting to OTC
15 markets, it's not a full SEC report.

16 And I don't know if anybody in the panel
17 looked at that study and said, this is an effective
18 market and it's a -- because I know with respect to a
19 lot of what I've done over the last couple years,
20 especially with foreign companies, they would come here
21 and say, we want to dip our toe in the water, whether
22 it's from German exchanges, Australian exchanges, a lot
23 of Canadian companies in the resource sector, etc., that
24 didn't want to go, say, fully to the SEC under MJDS and
25 register in the United States; we're taking this as a

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1 step.

2 And it seems to me, at least with respect to
3 the amount of trading that takes place there, that
4 there's got to be enough trading to provide some level
5 of good information to be able to decide whether it
6 works.

7 MR. SCHWARTZ: You're right. That's a great
8 point. The OTC market has tried to -- has tried to do
9 this. And I haven't looked at it extensively, but from
10 what I have looked at, they have not been that
11 successful.

12 So what would come close is the highest level
13 of the OTC market. I think it's OTCQX. That would be
14 kind of the most similar to what I would be proposing.

15 I think the difference would be -- and it goes
16 back to the point you raised on stigma. I think the OTC
17 really has a stigma attached to it, and I think that
18 prevents it from becoming this really true legitimate
19 alternative because it has a stigma, so companies
20 aren't -- aren't -- don't want to go there. I think OTC
21 has this reputation as being the place where companies
22 that are struggling can't meet the listing standards,
23 are going bankrupt, it has a stigma of being that
24 marketplace. So I think they haven't been able to
25 overcome that stigma, and I think that's one trouble

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1 they're having.

2 Another difference is that the regulations at
3 this OTCQX wouldn't be as high as I'm envisioning. At
4 OTCQX, you don't have to file Exchange Act reports. You
5 can do the OTC version of those reports. So it wouldn't
6 be -- it wouldn't be quite as high as what I would --
7 what I had in mind.

8 And finally, unrelated to that, the difference
9 that I see is that the OTC market doesn't have --
10 there's no SEC there telling them what their rules have
11 to be. So they're purely self-policed. The OTC markets
12 group polices the OTC because the securities laws don't
13 put any parameters -- don't put any parameters on what
14 their rules should be. Whereas from the market that I
15 envision, there would actually be this securities law
16 framework in place.

17 And I think that lends the market this

18 additional credibility, because when you just have a
19 market that's self-policed, I don't think it's a
20 credible market, and I think maybe that's also part of
21 the reason why it's not. It's not a substitute for what
22 I'm thinking about.

23 MR. GRAHAM: I want to just end things. Let's
24 pause the discussion so that Professor Bartlett can have
25 an opportunity to present.

0213

1 MR. BARTLETT: Sure. I can speak to some of
2 these issues about the market.

3 So first, I just want to thank you for
4 allowing me to share some of my thoughts on scaled
5 disclosure with you.

6 I also want to thank each of you for being on
7 this committee. I know you all have real jobs that
8 require an extraordinary amount of time. So the fact
9 that you decided to commit to this effort I think is
10 incredibly meaningful. It's very important work.

11 When Gerry first asked me to be on this panel,
12 it was something that I know is important because when I
13 practiced, I remember drafting 10-Ks and 10-Qs. And now
14 that I teach, I sort of sit back and I sort of observe
15 more generally sort of the evolution of these forms, and
16 it's clear there's this one-way ratchet that happens
17 with disclosure. Most of the time we're adding more
18 disclosure provisions, you know. So now we have
19 executive compensation disclosures, now we've got sort
20 of conflict mineral disclosures. It just keeps adding
21 on. You see risk factors too, right. I
22 suspect there's probably Y2K risk factors out there
23 somewhere still.

24 So it's great we have an effort that tries to,
25 you know, take a step back and rationalize whether or

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1 not we can actually have scaled disclosure that makes
2 sense. Because I certainly believe that's the case. At
3 the same time, I've also been daunted by the idea, and I
4 also tip my hat to you for taking on this task because
5 it's extraordinarily difficult to come up with optimal
6 disclosure.

7 I'm very pleased that Jeff and Steve are both
8 sort of more daring than I in actually coming up with
9 proposals. And I think they make a lot of sense. In
10 fact, I love this idea of sort of linking between SEC
11 disclosure documents and I'm thinking we can actually
12 plan to market something called a hyperlink. So
13 I think that would actually be a great addition of the
14 concept of EDGAR, basically come up with a way to use
15 technology in a way that makes it easier, doesn't kill
16 so many trees.

17 Okay. Well, what I'm going to talk about
18 today, though, notwithstanding this statement that I
19 actually want to see some unratcheting, some sort of

20 ratchet backwards, I'm going to talk about the
21 regulatory gap that I think you should fill. Okay. So,
22 in fact, Steve got wind of this and intended to leave,
23 but -- I'm just kidding, of course.

24 What I mean by this, well, what I want to talk
25 about is a regulatory gap that I think should concern

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1 us, if we're concerned about small and emerging
2 companies. Because the alternative of filling this gap
3 from the federal perspective is to allow the states to do
4 it, and we just don't want to have that. It's going to
5 increase the cost of capital, it's going to increase
6 complexity. I think it's something to be concerned
7 about.

8 So what I would like to begin with is just
9 sort of the conventional view of mandatory disclosure.
10 Generally, we sort of view the need for mandatory
11 disclosure as being driven by ownership structure. So
12 you might have privately held companies, family-held, on
13 one end of the spectrum, and at the other end of the
14 spectrum you've got dispersed shareholders, many
15 publicly dispersed shareholders, retail shareholders
16 that trade in the marketplace.

17 Now, we say that this is basically going to
18 map onto a disclosure regime, because if you're on the
19 far side, if you're a private firm, there's every reason
20 to believe you don't need mandatory disclosure because
21 your investors won't invest without contractually
22 getting rights to information. So this is a venture
23 capital model, for instance, right. That we don't have
24 mandatory disclosure there because we have sophisticated
25 investors that have a relationship and influence and

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1 they can get the information that they need.

2 That's different, however, if you have retail,
3 widely dispersed shareholders. You have large
4 information asymmetries between the shareholders and the
5 managers of those firms. There's also less of an
6 incentive to provide the information if you're not in a
7 capital-raising mode. And of course there's a
8 collective action problem because the investors may not
9 have, you know, the incentive necessary to demand the
10 information in the same fashion that a venture
11 capitalist would. So that's how we map our mandatory
12 disclosures by looking to the ownership structure. And
13 you see this in Section 12.

14 Section 12(a) basically says if you want to
15 trade on a stock exchange, you've got to be subject to
16 the Section 13 filing obligations, or if you have
17 greater than a certain number of record shareholders.
18 And sort of we'll table for the moment what that means
19 for a record shareholder.

20 So you have a certain number of shareholders
21 in ten million in assets, you also need to be subjected

22 to mandatory disclosure because we use that as a proxy
23 to say you're kind of in the public ownership space.
24 Okay. So therefore we're going to subject you to
25 mandatory disclosures.

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1 Now, to give you some examples, we have, you
2 know, plenty of private firms that don't disclose, or at
3 least privately owned. So Bechtel, for instance,
4 family-owned firm. Twitter, we say, you know, it's
5 generally a private company, for the most part, venture
6 capital investors and employee shareholders. On the
7 other end of the spectrum, you've got companies like
8 Google, GM. Zoom, it's a small -- it's a smaller public
9 company that trades on NASDAQ. And then we map that to
10 disclosure, which also is in some sense, it's all
11 spectrum, sort of, right?

12 So we have large accelerated filers that are
13 subject to all the rules. Then we also have smaller
14 reporting companies, which Jeff discussed, and Jennifer
15 provided a wonderful summary of a few meetings back, I
16 believe.

17 And so what we do is we then map these public
18 companies into their appropriate bucket, based on
19 whether they need the metric for smaller reporting
20 company status or otherwise the residual categories of
21 accelerated and non-accelerated filers.

22 These other firms, however, are not subjected
23 to Section 13. Okay. So the question to ask is: Should
24 we care about scaled federal disclosure in this? The
25 answer is yes. The reason I say yes is because if we

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1 don't regulate this from a federal matter, I believe, my
2 intuition and sort of my prediction is that we're going
3 to see increasing movement on the state front. So I
4 think that behooves us to think seriously about whether
5 or not it makes sense from both the issuer perspective
6 as well as an investor perspective to impose some form
7 of scaled disclosure in this space.

8 And one of the reasons I think this is going
9 to become more important, because that space has gotten
10 much, much bigger in light of the JOBS Act, because of
11 the fact now we went from 500 shareholders triggering
12 the thresholds all the way up to 2,000 non-employee
13 shareholders.

14 Okay. So that's basically why I think we
15 should care about this.

16 Just give you a quick outline of what I'm
17 going to talk about. I want to just go through in some
18 fashion the legal rules about why it is that these
19 private firms, these non-Exchange Act firms are in fact
20 subject to disclosure obligations.

21 I realize it sort of seems like a paradox or
22 just contradictory. So I'm going to explain why it's
23 not. I'm going to explain why there's some problems

24 with the state of affairs. And then lastly, I'm going
25 to explain what the Commission can do about it with its
0219

1 existing rulemaking authority. Okay.

2 So first, why is it that existing non-Exchange
3 Act companies are subject to disclosure obligations?

4 Well, let's take that -- take our dichotomy again.

5 Ownership on a scale, we also have a disclosure
6 vector as well. Let's not make it mutually exclusive.
7 So you have this two-by-two grid, right. You could have
8 on the one hand a privately owned company that
9 doesn't -- isn't subject to the federal regime.

10 So, for instance, Bechtel, okay, privately
11 owned. It doesn't -- it does not disclose anything
12 through the federal EDGAR system for instance.

13 On the other hand, you could have a public,
14 public company. You have GM, lots of dispersed
15 shareholders, and they also trade in the New York Stock
16 Exchange; and so, therefore, they're subject to Section
17 13.

18 But it turns out that these other two boxes
19 can also be filled. So to give you an example, Toys 'R
20 Us, privately held, went through a leveraged buyout a few
21 years ago. If you look them up on EDGAR, they're there.
22 Why did they do that? Anyone have a guess?

23 MR. WALSH: Debt.

24 MR. BARTLETT: What's that?

25 MR. WALSH: The debt.

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1 MR. BARTLETT: The debt, right. Because, of
2 course, the capital structure here is privately owned in
3 terms of the ownership, but it has widely dispersed
4 bondholders that was funded the LBO through high yield debt.
5 And so, therefore, the bond investors, through the power
6 of covenant, they say thou shalt file all Section 13 Act
7 reports because that helps facilitate the trading market
8 for high yield debt.

9 We also have this other category here. So
10 these are companies that are privately held. I'm sorry.
11 They're private in terms of their disclosure. They do
12 not show up on EDGAR, in terms of their Section 13
13 report.

14 But if you look at their ownership structure,
15 they're kind of public. In fact, on this spectrum of
16 ownership, they have drifted far from the family-owned
17 model, much toward the Google widely dispersed
18 shareholder model. So Twitter, for instance, got that
19 way because of SecondMarket and SharesPost, and the ability
20 to basically trade off the grid through private resale
21 transactions.

22 And likewise, Proxim Wireless trades on the
23 over-the-counter market it was formerly the Pink Sheets,
24 and rebranded itself on the OTC market. And I'd like
25 you to just take a look at Proxim, for instance, and why

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1 it is the case that I'm making a claim that this is a
2 public company that raises all the same problems that we
3 have with information asymmetry and the inability to
4 contractually get information that investors might want.

5 So if you go to OTC Market. Okay. Here we
6 go. And we added the Proxim symbol. So far this kinda
7 looks and feels like NASDAQ. You get Proxim Wireless
8 Corporation. You see the inside quote. You see the
9 price, \$1.55. You see the volume. Doesn't trade a lot,
10 but it does trade. You also get a lot of other metrics.
11 For instance, there is some financial information, but
12 it hasn't been -- they haven't filed any information
13 since 2010. Okay. This is a formerly public company,
14 public Exchange Act that went dark. They now trade OTC.

15 And they do in fact trade. So here, for
16 instance, historical trades of Proxim. You see it's not
17 a lot of volume, but in any given day you could have a
18 few thousand shares change hands. And these, of course,
19 are changing hands among dispersed shareholders. This
20 company, from an ownership perspective, is actually
21 quite far along the spectrum from private to public.

22 So my contention is that it's a publicly
23 traded firm and so it raises the same policy
24 considerations that have long justified mandatory
25 disclosure.

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1 Now, why isn't it subject to federal mandatory
2 disclosure? Well, that's just a function of the way
3 that the federal securities laws work. If you're a
4 securities lawyer, this will make a lot of sense to you;
5 if you're not, just trust me.

6 So basically -- so the way it works -- so if
7 you want to avoid Section 13 obligations, then you make
8 sure that you don't trade on the stock exchange, and
9 that you have fewer than the requisite number of record
10 holders.

11 And it turns out, by the way, that record
12 holders is actually just based on a formal requirement
13 of who is showing up as a stockholder record on your
14 books. Most shares are held in indirect form, so it
15 turns out that those number of record holders bears
16 almost no relationship to the number of beneficial
17 owners.

18 So the number of record holders of General
19 Motors, for instance, is a staggering 275. Okay. So if
20 it turns out that if General Motors decided to delist
21 from the New York Stock Exchange, it could go dark
22 tomorrow, okay, because it has fewer than 300 record
23 holders, which is all that's required in order to file a
24 Form 15 and go dark.

25 Okay. So in any event, though, this is the

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1 method that you do it, is that you would get off the

2 Exchange, and you have fewer than the triggering number
3 of shareholders.

4 Now, you can't raise any money because if you
5 want to raise any money, you're probably going to be
6 subjecting yourself to Section 5 of the '33 Act, which
7 requires registration. Okay.

8 But if you're not raising capital, as many
9 firms aren't, you can delist and you can stay underneath
10 this 300 shareholder record and you can be fine.

11 Now, your selling shareholders are also
12 subject to registration requirements, which could force
13 them to come up with a disclosure document. But it
14 turns out that the selling shareholders, reselling
15 shareholders and the dealers that work with them are
16 going to be exempt under some exemption to Section 5,
17 which is known as Section 4(1), 4(3) exemptions. So you can do it.

18 But that doesn't mean that you're not without
19 disclosure obligations. Why? Well, because you get one
20 great thing by being subject to all of these -- sort of
21 this onerous Section 13 reports. In exchange for
22 subjecting yourself to the conflict minerals disclosure,
23 you get federal preemption of state law. Okay. And
24 that comes about through something called Section 18 of
25 the '33 Act which says that if you are trading a covered

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1 security, then the state, they can regulate fraud, but
2 they can't regulate the disclosure documents that
3 pertain to you. And that's really important to
4 understand, because it turns out that each state has its
5 own separate securities regime. They're called Blue Sky
6 laws. They work just like the federal regime. They
7 basically enforce disclosure obligations and they police
8 fraud.

9 Okay. So if you are a company, you have
10 shareholders across the states, as many companies that
11 raise capital in our marketplace do, you have to worry
12 about complying with potentially 50 different state
13 regulations. This is a huge mess. It's been a long
14 mess ever since Blue Sky laws sort of were developed in
15 the early 20th Century. It became a special mess when
16 we then had a federal regime in the 1930s.

17 So you had a dual regime where you had to
18 comply with the federal regime and the 50 different
19 states. It was such a mess, in fact, that Congress
20 said, let's clean it up and create one standard, the
21 federal standard. This would happen in 1996 through
22 something called the National Securities Market
23 Improvement Act and basically created Section 18. Okay.
24 So as long as you're trading a covered security, you only
25 have to comply with one disclosure boss, and that's the

0225

1 federal government.

2 And the way that it works, it says if your
3 securities are listed on a major stock exchange, it's a

4 covered security.

5 Alternatively, if the securities are sold in a
6 Section 4(1) or 4(3) resale transaction and you're subject to
7 13, then you're also going to preempt the state law.
8 Okay.

9 Now, what happened is that when you have OTC
10 transactions occurring, those companies that are not
11 subject to Section 13 filing obligations and they don't
12 trade in an Exchange, they no longer have the power of
13 saying these are covered securities.

14 So as a result, these transactions are all
15 going to be subject to the litany of state securities
16 laws that regulate resale transactions.

17 And so, for instance, here in California we
18 have 25130, which basically says that it's illegal to
19 resell a transaction unless you file a disclosure
20 document. There's exemptions to it, but, as I read the
21 exemption, they are rarely met in a lot of resale
22 transactions that take place in these marketplaces.

23 So let's just take a look at these exemptions
24 that apply, right. So you're now off the grid. You're
25 at Proxim, right. How does Proxim make sure that

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1 they're not going to get in trouble with the various
2 state securities laws because these resale transactions are
3 taking place without being a covered securities?

4 Well, there's a handful of exemptions. These
5 exemptions are often mapped onto something called a
6 Uniform Securities Act. It didn't take long to figure
7 out the 50 conflicting securities laws, which are
8 complicated. So the national -- the state securities
9 commissioners did actually try to come up with a uniform
10 system of state securities laws. However, it's just a
11 template. So the states are free to tweak it around the
12 edges, and they have tweaked it considerably since it
13 came out in the 1950s.

14 But generally, the exemptions try to map onto
15 these three resale exemptions. And so one of them, for
16 instance, says that if you're not using a broker, if
17 it's like an eBay transaction, right, if I just decide
18 to sell a security to someone who is interested in the
19 market without using a broker, then
20 theoretically we won't worry so much about that because
21 it's brokers that we have to worry about, because, as we
22 have heard about this morning, they really get on the
23 phone and try to market a stock, okay, which might be a
24 concern for any number of reasons. So this unsolicited
25 resale transaction, it's going to be exempt.

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1 At the same time, we also have an exemption
2 that says if it's an isolated sort of one-off
3 transaction, even if it involves a broker, that can
4 be -- that can be okay as well, as long as you know --
5 if it's basically you're just -- you know, house caught

6 fire, you sell your -- sort of your holdings of Proxim
7 securities, it's the only time you ever sold it, we
8 generally allow you a free pass as well.

9 Likewise, there's always private resale
10 transactions. It's a -- in California, for instance, it
11 says if you sell to an accredited investor effectively,
12 it's also going to be exempt.

13 And there's also something called a manual
14 exemption, which is incredibly important actually for
15 complying state laws. And what it says is that if you
16 aren't subject to Section 13 and if you want to have an
17 active market in your securities on the OTC, what you're
18 supposed to do is you're supposed to file your annual
19 financials with a recognized manual. And the manual is
20 published by a couple of agencies, which tend to be agencies
21 rating as well as Standard & Poor's. Mergent is
22 one as well. And these are all publicly available and
23 so you're supposed to be able to go and look up Proxim's
24 last balance sheet.

25 Turns out, however, that it's not perfect

0228

1 because this is only possible in 37 states. The
2 conditions for being manual eligible differ in these 37
3 states. And the manual doesn't exist in certain states
4 such as California, which tend to be a large market. So
5 that's -- that's -- that's one limitation.

6 And there's one other thing, too, that
7 imposes, while I'm staying with these private
8 non-Exchange Act companies are actually subject to
9 disclosure obligations, is because there's actually a
10 federal rule that applies to a broker-dealer. And it's
11 Rule 15c2-11.

12 It says that if you want to quote a security
13 that's not on NASDAQ, it's not an exchange, then you
14 have to make sure that you get -- you receive from the
15 company some financial information. It's about 16 items
16 of information. It basically says that you can't
17 legally trade as a broker-dealer quote unless you get
18 these 16 items of information. So they include things
19 from basic corporate details, who the officers and
20 directors are, and some financial information, so
21 balance sheet and a recent income statement. So those
22 are some of the disclosure obligations that apply.

23 So that's why I contend that these
24 non-Exchange Act firms are in fact subject to disclosure
25 obligations.

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1 Now, what are the problems with it? Well,
2 first of all, let's take a look at the state resale
3 exemptions, why you might even be uncomfortable if
4 you're a company on OTC being subjected to these
5 requirements.

6 So the first one is that it's just complex.
7 Okay. So if you represent Proxim and you -- I mean, I

8 would sort of go running and screaming if I was aware
9 that, you know, the company wants to have investors or
10 raise capital across 50 different states potentially.

11 I feel fortunate that most of my clients were
12 in fact having covered securities, so that I only have
13 to worry about one federal regime, which is complicated
14 enough.

15 So, for instance, you know, what is an
16 isolated transaction? It turns out that you're going to
17 have to look how states have interpreted that, and they
18 might differ in how they interpret it.

19 For instance, likewise, has the state complied
20 with the manual requirements, which might differ across
21 different states as well?

22 What about these non-manual states, like
23 California; have you complied with their somewhat
24 idiosyncratic resale requirements? So it's complex in
25 order to have a compliant resale regime in this domain

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1 or to raise capital across these 50 states.

2 There's also the question about whether or not
3 these resale transaction exemptions still make sense.
4 And the reason I think that this is something that we
5 might see some movement on recently is that the space
6 that we're talking about here, these publicly traded
7 private firms is growing by leaps and bounds. It's
8 growing very, very quickly. It's going to grow even
9 quicker because of the JOBS Act.

10 And so this is a period of time where we might
11 see these provisions being tested by state regulators
12 and say, you know what, this unsolicited quote
13 transaction, I don't know if it makes much sense because
14 all of a sudden these broker-dealers are saying they're
15 getting tons of unsolicited interest. Why? Well,
16 because OTC marketplace is online. It's very easy if
17 you're interested in sort of trading, just sort of
18 submit an order that's not solicited just by virtue of
19 the technology of the OTC market today.

20 So you can see that this might be nearing a
21 time when some of these exemptions might simply
22 disappear. And in fact that has been the case in some
23 of the states.

24 And so, for instance, the manual exemption has
25 been eliminated in certain states in recent years as

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1 well out of concern that it's really not a very
2 functional way to assure investor protection in a
3 publicly traded over-the-counter marketplace.

4 And then likewise, I think there's reason to
5 believe that because of the complexity, because of past
6 attendance of only focusing on the federal regime, a lot
7 of companies just aren't complying with these rules. And
8 why -- and here's a quote, by the way, from "The
9 Corporate Counsel" talking about SharesPost and

10 SecondMarket. These rules all apply to those firms as
11 well. And they say: "Companies on these markets often
12 ignore the Blue Sky stuff; they don't require that
13 counsel's opinions address these matters."

14 And when I talk with participants in this
15 market, I am curious what these legal opinions cover,
16 because typically you're going to get a resale legal
17 opinion, and they tend to govern the '33 Act and they
18 don't cover state securities law, although I would love
19 to hear whether that has changed over time.

20 The reason I think that this is problematic is
21 because a lot of these state provisions have the same
22 remedy for violations of the registration requirement
23 that the federal regime is, which is rescission. And so
24 it very well may be the case a lot of people are walking
25 around with effective put options on the stock that they
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1 purchased in the over-the-counter marketplace, which can
2 create a huge mess in the event that the company
3 underperforms. And I'm not sure that this option is
4 actually being priced in the marketplace, as of course
5 it should be.

6 Okay. So as I said, these are some of the
7 problems. I think these problems may be -- oh. With
8 the state disclosure, here are some problems with
9 15c2-11 disclosure. This is not news. This is one of
10 the more critiqued rules that I've seen by the SEC.

11 Basically some of the problems are it only
12 governs initiation of quotations. So of course the
13 financial information that the broker-dealer gets could
14 get stale very, very quickly.

15 It doesn't cover at all the situation on
16 SecondMarket or SharesPost, where there's no quotation
17 being done by a broker-dealer. Those tend to be more
18 like -- well, SharesPost claims it's a patented bulletin
19 board. These represent customer interests. There's no
20 quotes there being offered. So it doesn't apply at all
21 in those markets.

22 There's no public repository of this
23 information as well. So it goes in a file of the
24 broker-dealer. And they have to make it available upon
25 request, but there's no public repository like there is,
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1 for instance, say, with the SEC.

2 And then there's a bunch of exemptions that
3 broker-dealers have to the rule, which also limits its
4 effectiveness.

5 So, for instance, it doesn't apply to
6 unsolicited quotations. This is actually dual-pronged.
7 Pink Sheets actually got concerned that broker-dealers
8 were saying, we don't need to have the 15c2-11
9 information to quote because we're getting unsolicited
10 interest. Because of course they could realistically
11 say, we're getting a lot of trading interest because of

12 the electronic platform of OTC market.

13 And then likewise, there's something called
14 the piggyback exception, which basically says that as
15 long as you see the market maker quoting a security, and
16 that security has been quoted for 30 days with no more
17 than four lapses of quotations, you can go ahead and
18 start quoting that security as well without having to
19 get the 15c2-11, even if the original person who got
20 that information has decided to stop making a market.
21 And so you can have piggyback after piggyback after
22 piggyback without anyone knowing even where the 15c2-11
23 form actually is.

24 Okay. So not surprisingly, this is -- again,
25 as I said, it's been heavily critiqued. It's been

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1 critiqued -- and there was proposals actually to amend it in
2 the '90s that never survived. There was a roundtable
3 market structure, a microstructure last October, I
4 believe, where this came up as well as in need of
5 potential reform.

6 This is -- the CEO of Pink Sheets describes
7 "Rule 15c2-11 is a rule of darkness," as opposed to a
8 rule of transparency.

9 Okay. So there's some problems, and these
10 problems are going to become potentially more serious, I
11 think, to contend with for companies that trade in this
12 space, the space as well that both Steve and Jeff are
13 talking about potentially to invigorate in terms of the
14 marketplace. I think these legal problems are going to
15 grow.

16 So to give you a sense, there are 3,000 OTC no-17
information firms. Okay. I looked in June, and there's
18 about 2,700. 300 more somehow appeared in just the span
19 of a few months. Okay. This is a marketplace that is
20 growing by leaps and bounds. And for reasons that you
21 can probably all understand, because who wants to comply
22 with the conflict mineral rule if you have a marketplace
23 where you have real liquidity without the need to comply
24 with any of the disclosure obligations?

25 Also, the reason I think that states are

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1 getting increasingly focused on this space is because
2 they already are concerned. So in response to the JOBS
3 Act, for instance -- here's the President of the
4 National Association of Securities Enforcers. His
5 testimony says we have -- and this is in specific
6 response to increasing the 500 threshold to 2,000, or I
7 think it was 1,000 at the time.

8 He said, "We do have concerns about drastic
9 changes in the thresholds for reporting companies or the
10 information they must disclose. The primary reason for
11 requiring a company to be public is to facilitate
12 secondary trading of the company's securities by
13 providing easily-accessible information to potential

14 purchasers. The principal concerns for states is the
15 facilitation of this secondary trading market with
16 adequate and accurate information."

17 So it's already on the radar. Okay. So this
18 is why I think that it could potentially be an
19 increasingly important issue for companies in this
20 space.

21 As they say, you know, Eliot Spitzer has had
22 kind of an interesting career. I think it might be
23 interesting for me as well to see where I might be able
24 to find some exciting regulatory initiatives.

25 So, again, it's just a prediction. I'd be

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1 happy to be proven wrong, but it's something, I think,
2 to take seriously.

3 So what can the Commission do about it? I
4 don't think doing nothing makes sense. A wait-and-see
5 approach is going to I think potentially be problematic
6 for companies because they're going to have to choose
7 between do I want to comply with these 50 -- you know,
8 these 50 different states and all the complexity that
9 imposes, or do I file Section 13 reports, as unappealing
10 as that is? That's kind of a Hobson's choice. I'm not
11 sure we really want to put companies in that position.

12 So what I think makes sense is a uniform
13 system of disclosure. I think that that actually
14 facilitates capital formation for smaller companies,
15 again, because it simply makes it easier to see your
16 transaction cost, people understand it. It's good for
17 investors because if it -- if the disclosure regime
18 makes sense, it can help eliminate some of the
19 information asymmetries that we all know drive the need
20 for mandatory disclosure.

21 So I'm a fan of uniform, a uniform system of
22 law. So all the Federalists in the audience, I
23 apologize.

24 So there are two rulemaking approaches that you
25 can take if you're the SEC. And as a Committee, I would

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1 urge you to consider these. I think one is superior.

2 So one is you could focus on 15c2-11. It's
3 got lots of problems. It's -- you could eliminate the
4 piggyback exemption. That's been proposed already. I
5 can't take credit for it.

6 You could make the information more easily
7 accessible, have a public repository. That's also
8 already been suggested, so I can't take credit for that
9 as well. In fact, I would urge you to go back to the
10 original proposal of 1998, I believe, to reform this
11 rule, because these problems with it are well-known.

12 Why might that help? It would help in the
13 sense that at least the problem wouldn't look so
14 dramatic to state securities regulators, right. They
15 wouldn't be able to point to 15c2-11 and say, you know,

16 this rule of darkness requires us to step in and
17 regulate.

18 However, it's not preemption. It's not a very
19 strong form of creating a uniform system. And so what
20 can the Commission do?

21 Well, it turns out that the Commission still
22 has Section 18 to work with, and it actually has some
23 rulemaking authority within Section 18 that gives it --
24 that creates the authority to reach into non-Section 13
25 Exchange Act companies and say, you need to start

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1 reporting on a scaled basis if you want to preempt state
2 laws.

3 Okay. So the way that this could work, for
4 instance, is two ways. One, the SEC was long ago
5 empowered to create a covered security if it was sold to
6 a qualified purchaser, as defined by the SEC. There was
7 a proposal once to say a qualified purchaser is any
8 accredited investor. That never became a final rule, so
9 this has yet to be defined by the SEC.

10 So one approach you might consider, if you
11 worry about this, is to say that, well, look, what we'll
12 do is we'll give you preemption, Proxim, conditional on
13 your selling to a qualified purchaser defined as an
14 individual who either has access to information or you
15 provide specified disclosure.

16 This is actually not a new idea, in fact.
17 This is how we long -- have long interpreted the private
18 placement rule, which says that you can sell to
19 sophisticated investors, but sophistication being
20 defined as either someone who has access to information
21 or someone who has been provided with requisite
22 disclosure documents.

23 Okay. So you can simply say a qualified
24 purchaser, just like we use -- do in the 4(1) -- or the
25 4(2) jurisprudence. We say that if you sell to someone

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1 who has access like a venture capitalist or someone who
2 doesn't necessarily have access, like a retail investor,
3 but you give them a disclosure document that has an
4 appropriate amount of information, certainly not all
5 Section 13 information, but maybe something that's
6 scaled appropriately for an over-the-counter company,
7 then you can get federal preemption.

8 An alternative approach as well is to say that
9 covered security includes a security sold in a resale
10 transaction under Section 4(1) or 4(3), which is most
11 non-insider resale transactions, if the company files
12 Section 13 reports.

13 So one approach is to do what high yield
14 investors do, is they say, we know that you're not
15 required to file Section 13 reports, but you can always
16 voluntarily file Section 13 reports. And so one
17 approach is to simply use that model and say, what we'll

18 do is we'll create a special set of Section 13 reports
19 that are only eligible to be used if you create the
20 right classification of a company.

21 That might be one of these companies that Jeff
22 was suggesting, that sort of -- you know, a small tech
23 company that doesn't trade on the New York Stock
24 Exchange. Or another criteria that indicate that we're
25 really trying to focus on the eligibility.

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1 To use these forms, you have to be like
2 Proxim, a company that doesn't want to be subjected to
3 Section 13 but trades in a public marketplace.

4 So if you do that, they may then voluntarily
5 choose to file these sort of lighter forms of Section 13
6 and then claim that the resale transactions are exempt
7 because they're done under 4(1) and 4(3) and we are
8 voluntarily filing Section 13 reports; and so,
9 therefore, these are covered securities.

10 So those are two approaches I think that make
11 the most sense because you get federal preemption. And
12 I think this is sort of, at least in my mind, an issue
13 that is going to increasingly become a problem for small
14 and emerging companies that operate currently in this
15 unregulated space beneath, well, 2,000 shareholders as
16 of today. So that's all for that.

17 MR. GRAHAM: Thank you, Bobby.

18 Couple more minutes before we break at 3:00.

19 Any more questions for Jeff or Bobby?

20 (No audible response.)

21 Hearing none --

22 MS. JACOBS: Yeah, why don't we take a quick
23 five-minute break, and then we're going to open up for
24 discussion. And, please, as many members as possible
25 hang around because this is where we're going to need

0241

1 y'all.

2 (A brief recess was taken.)

3 MR. GRAHAM: I'd like to get started with the
4 discussion, kind of our -- kind of our discussion part
5 of the afternoon. Surely, it's one of the more
6 important parts. I wish that we had more time for it,
7 but we don't. And I also understand that there are a
8 number of people that have planes to catch, and so -- I
9 think maybe before we actually conclude, so I want to
10 get started and give everybody an opportunity to weigh
11 in a little bit.

12 Again, so going back to what we said this
13 morning, the purpose of today was to look at two general
14 areas and think about what kind of recommendations we
15 can make with respect to those areas that would help
16 further the interests that we're trying to further as a
17 committee.

18 Those, of course, are the structural issues
19 that we find in the marketplace, number one, and, number

20 two, the scaled disclosure.

21 You know, I think what I would -- what I would
22 like to do is have a conversation. We heard -- we've
23 heard a lot things today. I think some were kind of
24 more interesting from kind of a broader -- kind of a
25 context point of view; I think others more directly

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1 related to what it is that we're trying to accomplish in
2 terms of coming up with specific recommendations.

3 So what I would like to do is begin the
4 conversation and, at least before we break, have a
5 sense for where we feel we should be headed as a
6 committee.

7 If one or two specific recommendations fall
8 out of the discussion, great. If not, that's okay too.
9 But let's begin the discussion. And then I think what
10 is likely to happen is that following this meeting we
11 will -- you know, Chris and I will think about what
12 we've heard and begin to kind of draw some
13 recommendations into focus that we've been discussing to
14 help finalize.

15 Before we kind of open it up for discussion, I
16 think Chris has a couple of things she would like to
17 say.

18 Is that true?

19 MS. JACOBS: Yeah. Just to begin to set the
20 stage for the discussion, we've spent several meetings
21 on the IPO Task Force, the IPO on-ramp. And as we begin
22 the discussion this afternoon, maybe ask y'all to change
23 momentum here a second and look towards day two.

24 The one thing I know, as a sitting CEO, is you
25 don't ever create or set up with your company with your

0243

1 IPO as your end game. Your IPO should be the beginning
2 of your next step. And that next step and what that
3 environment entails for us is what we need to discuss
4 today. Because the environment for these public
5 companies, day two. Once the IPO is finished, we have a
6 set of rules and regulations that are well documented as
7 being a burden.

8 Professor Schwartz, I'll probably be putting
9 you in my will sometime next week because you hit a lot
10 of the points that I think we -- I'd like to see us
11 cover.

12 And I would like to hear whether you're an
13 investor. And maybe as investors, y'all don't have a
14 dog in that hunt, but to those of us that are associated
15 with small reporting public companies, there's a lot of
16 reform that could be done now that's not quite the
17 burden of perhaps a new set of markets. Because we've
18 got that -- let me give you an example.

19 We've got the \$75 million market cap as the
20 hurdle for exemption. Well, as you brought up, Professor
21 Schwartz, why is that 75 million, when the JOBS Act has

22 given a hurdle rate of a billion dollars in revenue
23 and five years of reprieve? There is a real disconnect
24 here.

25 And so all I wanted to do is sort of set the
0244

1 stage on what we were hoping we would hear from you this
2 afternoon about scaling and that day two for these
3 public companies.

4 MR. GRAHAM: One last maybe point of order,
5 how would you guys like to manage the discussion? I
6 would like to hear from everyone.

7 MR. SUNDLING: Free flowing.

8 MR. GRAHAM: Would you like to comment on both
9 scaling and the kind of market issue, or shall we spend
10 a half an hour on market issues and then switch over to
11 scaling?

12 MR. SUNDLING: I think it depends on who's
13 speaking.

14 MS. JACOBS: Yeah.

15 MR. SUNDLING: And -- yeah. If you don't -- I
16 don't know what everybody else thinks, but I think that
17 the opinions and the things that people might want to
18 talk about are going to differ depending on your
19 background, what company you're representing here.

20 MR. GRAHAM: Oh, absolutely. I don't disagree
21 with that.

22 So why don't we just kind of start with maybe
23 the structural issues, and some people have more to say
24 on that and others less, and then we'll move on to the
25 subject of scaling, if that's okay.

0245

1 So we've heard a lot about tick size, whether
2 that matters. I guess what I'd like to do is, again,
3 just kind of open things up for discussion, think about
4 what we might want to say about that as a committee.

5 Does anyone want to start?

6 MR. SUNDLING: I'll start, if you don't mind.

7 MR. GRAHAM: Okay.

8 MR. SUNDLING: But if you don't mind, I'd like
9 to back up just a little bit.

10 So first of all, the speakers and presenters
11 here today have been phenomenal. Thanks for your
12 participation. I know I learned a lot, probably a lot
13 of -- you know, there was a lot of information there
14 that I don't think I absorbed today, maybe never will.
15 Some extremely deep expertise from David on the way
16 the trading markets work and from the professor on kind
17 of the observation around -- you know, I saw a lot of
18 analysis done on just charts of what the markets are
19 doing.

20 But I think, you know, if we back into what's
21 the charter of this committee in looking at capital
22 formation is one problem, and a form of capital
23 formation is going public, right. So you go public to

24 raise money, and then, you know, as Christine said, then
25 what's your Phase II once you are public?

0246

1 And so coming from the angle of a sub \$50
2 million software company, right, so everybody -- we got
3 investment bankers here, we got regulators, and folks
4 from the academic world -- from my perspective, if
5 you -- and I belong to a lot of groups, right, with a
6 bunch of other CEOs that are in the same -- probably in
7 100 million and below software space. You don't even
8 talk about IPOs anymore, right.

9 It's -- and I think we have to realize that,
10 for all intents and purposes -- you know, I keep
11 thinking about the regulatory changes they're talking
12 about. That's akin to kind of just bumping this can a
13 quarter inch at a time, and it needs to move five feet,
14 right, to really get people excited about the objective
15 of becoming a publicly traded company.

16 There's got to be radical reform, not just
17 around regulatory requirements. But I think there's a
18 marketing problem, right. I think that if you turn the
19 clock back to 1996, the only thing anybody ever talked
20 about was the IPO.

21 You talk to any of these CEOs, and we're --
22 you know, we're trying to extrapolate from these market
23 statistics and all these other things what they might be
24 thinking. It's easy. Just survey them. Call them. I
25 talk to them all the time. And I am one of them, and we

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1 would never consider an IPO.

2 And with all due respect, right, if the idea
3 is to figure out -- you know, all the things that I even
4 heard in the last few hours and then in prior sessions
5 is you're not selling me on going public, that's for
6 sure, right. It's --

7 MS. JACOBS: Why is that, Charlie?

8 MR. SUNDLING: Well, I think just -- it's
9 just -- it's difficult. And when you look at the exit
10 options, you always have to see what is the competition.
11 The competition for liquidity is M&A. The M&A market's
12 red hot, right. It's not hassle-free. Nothing is.
13 But really compared to going public, it's an easy way
14 out. You've got investors.

15 You know, when Steve was here, I think it was
16 he who made the statements from a VC perspective, right,
17 there's kind of two things they look at. One is in the
18 initial discussions, who's your buyer, you know we're
19 going to put money in you, who are the most likely
20 buyers, which is a very fair question.

21 And from an IPO perspective, it's -- I think
22 he said a hundred million in revenue or bigger, and
23 market cap, you know, day one IPO, nearing the billion
24 dollar mark, before you get any, you know, of the A
25 player anyhow, i-bankers involved in your deal.

0248

1 But I think the perception that I have, and I
2 spend a lot of time, and I realize the complexity. We
3 do a lot of complex stuff in our business, right. Our
4 customers are very big global energy companies, nuclear
5 power producers. So everything we do is complicated.

6 I'm not afraid of complicated. When I look at
7 what it's going to take to go public and remain public
8 in all those -- you know, until you reach a very
9 substantial scale, it's not even the money, a million
10 bucks a year, whatever, to pay the auditors and all
11 that. It's more the risk. It's the distraction from
12 your business. It's the fact that, from a liquidity
13 standpoint, it's a lot easier to get a big check from a
14 strategic buyer, right.

15 And so I think in looking at -- so there's the
16 two things that we've maybe been -- the two big things
17 anyhow brought together to discuss is access to capital,
18 and then somewhere along the line this whole discussion
19 about IPOs came in because I think it related to access
20 to capital, as far as I can tell.

21 And then you get into the systemic functioning
22 of the market, right. So on the trading side, right,
23 the things that David brought up about, you know, the
24 spreads and on, you know, the decimalization and all
25 these things that are kind of impediments to that side

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1 of the market.

2 You combine that with kind of the -- you know,
3 this whole notion of what still sticks in the minds of
4 every entrepreneur I know is when Sarbanes-Oxley came
5 out, you wrote off the IPO thing. It's not even really
6 talked about. And it comes up once in a while, but it's
7 really -- you know, if you've got a business model
8 that's a potential rocket ship, like a Facebook, you
9 know, the other dimension. And you really got to get
10 into the details.

11 I would really recommend that in the research
12 that's done you -- there's -- you drill down into some
13 of the more detailed aspects of this round of psychology
14 of the CEO and the board and the VC, then map it across,
15 you know, all those metrics over the years.

16 And I would bet one of the things you find are
17 things like, you know, the -- depending on what market
18 you were in, if you were in the B-to-C world, well, you
19 know, that's something where you can go public, you can
20 remain independent, and you could have a grand slam
21 because you're selling to an emotional buyer, right. You
22 look at the IPOs, Facebook, LinkedIn, Groupon, they're
23 selling to an emotional buyer, to consumer.

24 If you switch over to the B to B world, right, if
25 you're an enterprise software company or a SaaS

0250

1 provider, look at the competition, and your likelihood

2 of surviving as an independent company and growing and
3 getting anybody interested in your stock, right, and I
4 think what you find is there has been massive
5 aggregation in the tech space. There's going to be ten
6 big companies left on the planet at this rate, right.
7 Most of them have acronyms for names.

8 And at the end of the day, right, if you are
9 going to remain independent, those are your competitors
10 in the B to B world. Our smallest competitor has a \$64
11 billion market cap. That's the small one, right.

12 So can we compete with them? Not over the
13 long-term, right.

14 Well, what we and most of the CEOs I talk to
15 that are in this kind of boat, what they do themselves
16 is outsource R&D for big companies, right.

17 What we're trying to do is build a product and
18 out-engineer them, get it to market. Can we ever
19 compete globally when they dominate the channels of
20 distribution and all the servicing integration partners?
21 No. Right. All you can do is put yourself on the
22 tracks, right, and hopefully get a bidding war going
23 between a few of them that all want that piece.

24 I think it'd be really interesting to map all
25 these charts against the M&A in the growth of these big
0251

1 companies.

2 Again, in our space, you know, if you look at
3 the big companies in this -- and I think someone
4 mentioned a recent IBM acquisition in this group. Just
5 look at the size and scale of these companies. On one
6 chart where it said what are the impacts -- the
7 impactful items to people wanting to go public or remain
8 public. One of them was this -- it was -- I can't
9 remember the term, but it was about the scope, the
10 example that was given earlier about the refrigeration
11 truck, right, the ice cream and the milk.

12 I think -- and that was rated as not
13 important. I think that is massively important, because
14 out there in the competitive world, what happens is you
15 have a product that -- and you look at profitability.
16 So this chart that shows small companies aren't
17 profitable. Well, yeah, because you have to fund
18 overcoming that channel dominance and effective
19 monopolies of control in these customers in the B to B
20 world.

21 I would suspect that's not true when you look
22 at consumer-oriented target markets, although in some it
23 may be true.

24 But absolutely in tech, B to B, it's all about
25 distribution, right. And those are very tightly
0252

1 controlled quasi, almost cartels, right, that used to --
2 what was the saying, right, you don't get fired for
3 buying IBM. Well, you don't get fired for buying HP,

4 you don't get fired for buying Dell. Right. You could
5 get fired for buying Pipeline, because nobody knows who
6 we are. We're very specialized and, in our niche, the
7 best at what we do.

8 But there's a very kind of dominant evolving
9 market of really big companies that nobody wants to
10 compete with. You certainly wouldn't want to go public
11 and get hammered for a couple of quarters. And when you
12 look at what your marketing spend is to overcome some of
13 these distribution channels, that's why the
14 profitability is low.

15 So bottom line to me is -- and again, you
16 know, I don't think it's a Charlie-ism. I think it
17 would be great to, you know, let's do a survey and talk
18 to all these people and they'll say the same thing, is
19 you're crazy for going public, right. You built some
20 value, try to lock down a patent or two, get a little
21 bit of leverage, and then you sell.

22 MR. GRAHAM: Now, when you say you're crazy
23 for going public, how would things have to change?

24 MR. SUNDLING: Well, so that's a great
25 question. And I've been -- and I'm trying to remain

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1 optimistic, believe it or not, and trying to think what
2 if, again, someone was trying to convince me to go
3 public, what would have to change?

4 And, you know, it's actually pretty tough to
5 say because I think that the fundamental market has
6 changed and your chances of survival in a public market,
7 it depends on the size of the company. If you're sub 50
8 million, one of the great things about being a small
9 private company is you don't have to tell anybody what
10 our revenue is or what anybody is getting paid, and all
11 these things that competitors are going to pull right
12 out of your Qs and Ks and use against you, maybe even
13 customers will. Our customers are very, very large
14 companies. You know, so there's the dimension of
15 disclosure and risk, right. So you put financials out
16 there for the world to see, again, depending on what
17 kind of shape you're in and what you're trying to do,
18 you may not want to do that.

19 What would need to change, right, is -- it's
20 probably a whole bunch of things, but at the end of the
21 day, they all add up to risk mitigation. If I were to
22 go to my investors and say, hey, I want to go public --
23 I mean, I don't even know how that story could be sold,
24 right, because the other thing that's happening --

25 MR. GRAHAM: Certainly not in today's

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1 environment.

2 MR. SUNDLING: Well, you can't. And a big
3 part of that reason is the lucrative nature of M&A,
4 right. So the private company deals that are getting
5 done, the volume of them, the multiples being paid by

6 strategics. You know, unless you think you've got
7 something that's going to be a 20-year business, right,
8 and exist in perpetuity -- which I think is not in the
9 mind set anymore, right.

10 And I can remember the days, right, and I'm
11 sure y'all do as well, that the only discussion ever was
12 about building a great company that's going to last a
13 hundred years, and it's going to be billions. And
14 everyone was, you know, drinking the same Kool-Aid.

15 Well, Kool-Aid these days is, right, highly
16 leveraged investments that even VCs, they're doing these
17 tiny rounds. They want to just see proofs and
18 technology, very incremental, and they're looking for
19 the tenbagger that might be under a 50 to 100 million
20 dollar total deal, right, which means total investment
21 is going to be 2 to 10 million.

22 That's the other thing that we're seeing is,
23 you know, the -- other than the very rare, exceptionally
24 large transactions, that lower end market is really
25 research for big companies, right.

0255

1 One of the -- I mean, one of the potential
2 theoretical remedies to the whole thing is what was
3 discussed earlier, which is just a completely different
4 alternative market, right.

5 The one that I used to follow that was
6 interesting is this whole London AIM thing. I don't
7 know if you guys pay much attention to it. But I
8 remember some British bankers telling me, yes, just the
9 public venture capital, right. Is the reporting -- you
10 report once a year. You get this thing called a nomad,
11 who's your nominated advisor. All the requirements are
12 very low. And everybody knew that effectively this
13 thing was just a way to raise money. Easy, very low
14 regulations, didn't distract you from your business, and
15 gave you some kind of liquidity.

16 It's not, you know, an actively traded, you
17 know, volume traded stock to where all the investors are
18 liquid, but now you've at least got a vehicle where you
19 can bring in institutions and other things, and founders
20 can liquidate some of their stock. So some kind of
21 alternative vehicle, maybe a modified version of the OTC
22 would be interesting. I don't know.

23 But, you know, I think in the U.S. in general,
24 nobody would argue that we really kind of put the
25 regulatory screws to all of this. And now it's got

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1 to be spun back. But even after they are, I would argue
2 it's a five-year marketing job to unwind it, right. So
3 is everybody prepared for another decade of slow small cap
4 IPOs? Because I think realistically that's probably
5 what's going to happen if you fixed it today.

6 MS. JACOBS: I didn't hear. I want to make
7 sure, though. I did hear you say that the regulations

8 are as much an impediment as market structure?

9 MR. SUNDLING: Yeah. I think there's
10 multiple -- yeah, regulations, market structure, and
11 whatever you want to call it, the change in psychology
12 of the executives and to some extent the investors.

13 MS. JACOBS: Right, the macro.

14 MR. SUNDLING: Yeah.

15 MR. GRAHAM: Okay. David, I know, has got to
16 leave pretty soon.

17 So before you do, anything you want to say
18 besides goodbye?

19 MR. BOCHNOWSKI: It's been a great day. You
20 know, the evidence that we saw is that there was a
21 period when the IPO market was something everybody
22 wanted to do. Clearly we're not going to go back to that
23 time. There's no way to change things that have
24 occurred.

25 I believe that Professor Schwartz, he'll be in
0257

1 my will, too, because I think at least he's given us a
2 path to whatever the future is going to be. I think we
3 have to think about what that future is going to look
4 like.

5 Many of these issues don't really directly
6 relate to me as a CEO because I'm a community banker.
7 Where it does relate is that we know that the IPOs
8 created more jobs over time, and that gets back to what
9 I do every day. And the more jobs there are, the
10 happier bankers are.

11 So I think we've got to figure out a way to
12 come up with a new regime, and I think that's what
13 you're suggesting. And we've got to create whatever
14 that future is so that the economy can continue to
15 thrive.

16 I thought that one of the things I learned
17 today was very instructive to me, and that was when you
18 shifted to the electronic order book. Where that
19 discussion impacts me as a company is that every time
20 our stock has been slammed down -- and we have an
21 average volume of under 200 shares a day -- it's always
22 happened electronically, never happened through the
23 book.

24 And so I think there is that investor class
25 and there's the trader class. The trader class is not
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1 helping what we all do every day. And I think that has
2 to be addressed.

3 On scaling, clearly the idea that my company
4 or any company that is of our size has to report at the
5 same level and do the same things every day that the
6 very large companies that do offer systemic risk to the
7 American economy and to investors is the risk management
8 portion of this that I think we need to address as a
9 group. And we have to be sure that the risks that some

10 of us take on and the rewards that some of us have for
11 taking on those risks are scaled appropriately to
12 whatever might happen within the economy that would be a
13 negative to the overall status of our nation.

14 But some of us clearly don't offer those
15 systemic risks and shouldn't have to go through the same
16 things as those who do. So that's why I applaud what
17 you -- the seed you have planted.

18 MR. GRAHAM: Milton.

19 MR. CHANG: I think we're not going to roll
20 the clock back. I think if we can fight them, I think
21 we should think of ways to supersede them.

22 My prediction is that the IPO market is going to
23 continue to be in bad shape for the foreseeable future.
24 Because if you look at the feeding part of it, in terms
25 of where VCs park their money, is mostly in the web and
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1 mobile space, where tends to be very -- just very little
2 product differentiation where the ticks are off. And
3 you're going to have very few IPOs for big ones. Where
4 on the manufacturing side, product side, there are room
5 for differentiation; therefore, there are many IPOs.

6 So I don't think that's going to be changed in
7 the sense that's the investment trend on the feeding
8 end.

9 And I think the objective is about job
10 creation and economy. And if that's the case, M&A is
11 probably just as efficient, if not more so, than IPO,
12 because scaling is much more efficient in a big
13 corporation.

14 So M&A in fact is a very efficient way of
15 scaling the businesses once it's incubated in a small
16 company.

17 And I think the capital formation is really
18 the key to growth. And I think that's in fact the
19 charter of the SEC.

20 And I think two personal experience that's not
21 being discussed: One is the -- in the good old days you
22 can walk into Cisco and you say, I want to develop this
23 technology. And you can come out with an agreement
24 where you will be bought when your objective is
25 accomplished. And you use that piece of paper to go out
0260

1 and raise money.

2 That can no -- that's no longer allowed
3 because that's kind of external R&D funding. So you
4 have to write it off on your bottom line. And that's a
5 detriment to -- in terms of getting VC funding.

6 And then the other one is the allocation of
7 the R&D tax credit or tax loss. Those are great
8 incentives to attract investment capital into the
9 startup community, and both of those are gone today.

10 So I think those are the systemic issue that
11 we can really sort of recommend to make a difference.

12 MR. GRAHAM: You know, this -- you know, we
13 talked about scaling. And it relates directly to
14 capital formation because we've got companies -- I mean,
15 there's a bigger hurdle than that, you know, with
16 companies like Charlie's who say they don't want to go
17 public. Nonetheless, that is -- that is a -- that does
18 provide headway for people who do want to at least
19 consider the IPO.

20 Then in terms of -- we talked about capital
21 formation, and kind of related to that is that if I can
22 save a million dollars in compliance costs, that's a
23 million dollars I can use in my company.

24 And it really -- you know, it really seems to
25 me that -- that when you think about how you can

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1 accomplish this, that more and more we should be
2 thinking in terms of the principles we apply in this
3 context. Because it seems to me that kind of a basic,
4 you know, tenet of what we're dealing with here is
5 disclosure and what is and what is not material. And it
6 seems to me like that materiality doesn't necessarily
7 depend on market cap or revenue or how long you've been
8 public.

9 MR. CHANG: I think I'm in 100 percent
10 agreement with Charles. What he essentially said is
11 take it one inch at a time, five feet at a time. That's
12 the back end. The front end is the capital formation.

13 MR. GRAHAM: Right. But my question is in
14 context for anyone to respond to, investors in
15 particular: What is out there in the way of compliance
16 that you see that you don't need?

17 MS. JACOBS: Here's a question: For those of
18 you that invest in public companies, is the disclosure
19 in and around conflict minerals going to be material?
20 That's a simple one, I think. But you have to tell me
21 or -- because we had this discussion several months ago
22 when we even discussed the CD&A, pay-for-performance,
23 the frequency of pay-for-performance. I mean, the list
24 goes on and on.

25 MR. CHACE: I can tell you that the way we use

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1 public documents, the research companies, the 10-Ks and
2 the 10-Qs, for the numbers, for the business
3 description, for the footnotes to financial statements,
4 the management discussion and analysis which I think is relatively
5 straightforward.

6 (Outside noise.)

7 The compensation disclosure is much less. I
8 think it's really (inaudible) put together. It's not an
9 area where we typically focus -- I can't speak for every
10 investor, obviously, but I think that we spend a lot of
11 time talking about it, try to gauge their motivations
12 from that. Compensation is a part of that. It really
13 is (inaudible). We're looking for people that are

14 founders, inside owners as well. (Inaudible) complex
15 pay structure. Conflict minerals is (inaudible).

16 MS. JACOBS: Okay. So we got one.

17 MR. DENNIS: I think the question on the
18 conflict minerals is, that's in the law, right. Congress
19 wrote that. It wasn't written for customer protection.

20 I think the question is to the SEC staff: Do
21 we have any flexibility here? Because the law is pretty
22 clear. As I understood it, it said you will do this.
23 And so does the SEC staff have any ability to exempt
24 companies under a certain size? I don't know the answer
25 to that.

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1 MR. NALLENGARA: The final rule, which was
2 adopted late last month, didn't exempt any company. And the
3 reason for that is expressed in the final rule, is that
4 the congressional mandate in Dodd-Frank didn't
5 provide -- didn't contemplate anything other than all
6 reporting companies have to do the -- have to do
7 disclosure. There is some phasing provided for smaller
8 companies.

9 MR. DENNIS: You know, it's like a
10 four-year --

11 MR. NALLENGARA: Four-year.

12 MR. DENNIS: So we got four years to get
13 Congress to change the law, kind of how I --

14 MR. NALLENGARA: Well, it's not really four
15 years. After doing four years, they don't have to -- you
16 know, there's a varying -- without getting into -- and I
17 think we're all in painful detail of the rule, there are
18 some variances, there are some stages of work that a
19 company would have to do. Whether you can certify and
20 get an audit saying that your stuff is conflict-free is
21 at one end.

22 And a smaller company can for four years
23 effectively say they haven't been able to determine
24 whether it's conflict-free. So it's still work for them
25 to do, but it's a part of -- it's part of an elaborate

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1 transition mechanism, smaller companies have a longer
2 transition.

3 So I mean, this is -- and I don't think
4 anyone, at least -- I'm from the staff perspective, I
5 think the Commissioners, I don't think anyone is
6 thinking this is disclosure that an investor determining
7 whether they're going to buy or sell its security is
8 looking for. This is not that. This is -- I mean,
9 that's not what the purpose -- I don't think that's what
10 the purpose of -- if you look at Dodd-Frank, that wasn't
11 the intended purpose.

12 So when you look at materiality, it's probably
13 not the best lens to be looking at this Act, because I
14 don't think that was the lens that anyone who --

15 MR. DENNIS: But I think it does show a

16 dangerous trend of Congress using this organization as a
17 way to social engineer something that is not in its
18 mandate, not in its charter. And I don't expect you to
19 comment.

20 MR. NALLENGARA: No, no, and I'm grateful it's
21 not webcast, so --

22 MR. DENNIS: We can make a recommendation
23 that -- maybe the recommendation, Christine, is that we
24 try to seek congressional action on this in some way.
25 That's probably the answer to this. Maybe that's how we

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1 form our recommendation.

2 MS. JACOBS: Well, okay. That's one
3 suggestion. But then I'll throw another one out to the
4 folks that are investors. XBRL.

5 MR. CHACE: I am not certain how much we use
6 it directly. I mean, the word -- and we use basically
7 the filings to plug in our own numbers. It's not clear
8 to me how XBRL makes my life better. We do use a lot of
9 financial information providers that probably benefit
10 from XBRL that we use to download data. So they have
11 some secondary positive effect on us, but not
12 day-to-day.

13 MR. LEZA: Can we get back to jobs, get back to
14 access to capital, which is basically why this group was
15 formed for. I like to separate it in two ways here to
16 make a comment, one from the private side, and one from
17 the public side.

18 From the private side, I was involved in
19 startups in six companies. One of them failed, five
20 were acquired in M&A. Okay. And there was three
21 things that you looked at. And the animal has changed
22 from IPOs, the way I see it.

23 Okay. The first thing you look at, risk. You
24 look at risk. And you kind of evaluate what my options
25 are going public or what my options are going M&A.

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1 The second thing you look at is, what kind of
2 money am I going to get based on IPO and based on M&A?

3 If you look at it, M&A has been swinging to
4 where they used to have a multiple one or two, and now
5 they're paying seven or eight. Now, so you kind of look
6 at it and say, I mean, I can get seven or eight. I'm
7 not tied up. There's no locking. I can -- my stock can
8 be, you know, liquid in no time. And since it's a big
9 corporation, I can sell immediately because I don't hold
10 that much of a percentage based on the large
11 corporation. So the animal has changed from the private
12 side.

13 So a lot of the companies that you see, they
14 look at risk, they look at how much money.

15 And then the other problem that they look at,
16 and I think this is one big problem, is all of a sudden
17 you've got two things. From the private side you go in

18 and you look at it, and all of a sudden it becomes
19 performance quarter to quarter. They don't care about
20 the long-term. It's quarter to quarter. And people do
21 not like working like this. When you're private, you're
22 looking at three to five years, and you're making
23 decisions in three to five years.

24 And this thing about, I need to be looking at
25 it quarter to quarter, you spend so much time doing that
0267

1 and trying to see what you need to little tweak and
2 stuff. And you look at this and say, hey, it's a choice
3 here. It's not that -- you know, I can understand some
4 of the presentations and some of the stuff, but I think
5 the pendulum has changed.

6 From the public side, being involved with
7 public companies and market cap all the way from I would
8 say, you know, 70 million all the way to 450 million,
9 you look at that from the private side.

10 And I can understand SoX, you know. And like
11 I said before, when we implemented SoX, for the first
12 two years the expense went up, and it went up quite a
13 bit, you know.

14 But then within the next two or three years,
15 there was certain things that were implemented, and we
16 brought the cost right back to where it was before.
17 Okay.

18 So I don't think that that is something that
19 prevents things from creating a bigger company or adding
20 jobs or stuff like this. I think regulations, yeah,
21 they're an irritation, but I don't think that that's
22 something that keeps the people from thinking
23 differently.

24 I still think the focus -- what becomes
25 important is that access to capital. I need to get more
0268

1 money to do more things. And a lot of times what
2 happens is you're in the public company, you've gone
3 public and you've got money, and it depends how you look
4 at it.

5 In a semiconductor company, we had a company
6 that was sitting there, we were growing double digits,
7 but -- you know, and we had \$250 million in cash and we
8 were doing something like -- our revenue was like \$80
9 million, and, you know, we were public.

10 But then another company came in and said,
11 look, if we consolidate, we can buy and do this, do
12 that. The numbers were right, so we said, okay, let's
13 do it. It's not that we didn't want to be public; it's
14 just that the economy and the choice became greater by
15 consolidating and selling out.

16 The thing that we have to look at is that both
17 private and public companies create jobs when they have
18 access to capital, and I think that's the thing that we
19 gotta look at more closely and see what we can do to

20 relieve some of the constraints so that people are more
21 freely picking up capital and being able to grow in a
22 faster rate than we can have.

23 MR. GRAHAM: Right. Can't disagree with that.

24 MR. SUNDLING: I think one of the key points
25 in there if I can chime in that I think that can't be

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1 lost in this discussion is those multiples and how it's
2 swung. So I remember -- this is not being webcast,
3 right?

4 MS. ZEPRALKA: It's being recorded.

5 MR. GRAHAM: Recorded.

6 MR. SUNDLING: Oh, it's being recorded. Oh.

7 Well, then, I won't go through that example, but --

8 There was an event back in around the dot-com
9 boom days. And, you know, we had an offer on the table.
10 And at the time, right, it's exactly what you said, is
11 M&A, the multiples were pretty modest. You know, there
12 were 3X, and there were -- there were, though, these
13 ridiculous dot-com deals happening.

14 But on the M&A side, you could expect a
15 reasonable return, but there was no limit on an IPO
16 because you'd have -- and there were a couple
17 companies -- won't name their tickers, but one of my
18 favorites had 63 million in revenue and a market cap was
19 \$16 billion, right. And so everybody -- you know, we
20 all knew deep down that wasn't going to last, but that's
21 what you were going after.

22 Now it's all about the alternatives. So, you
23 know, we had some nice offers, and we turned them down,
24 which today, these offers would be -- you know, you'd
25 jump on in a second, right. But it was because of the

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1 alternative opportunity and an IPO was worth the risk
2 and all the other things that come with it, because it
3 was just ridiculously different what you could do if you
4 had a successful IPO you -- taken out early.

5 And that's changed, right. So now it's more
6 about those multiples are up, because look at who the
7 buyers are. Just check the balance sheets of all these
8 big -- they're sitting in aggregate hundreds of billions
9 of dollars in cash looking for something to do. They're
10 all on buying frenzies, right. They're taking all the
11 components they need to grow these massive companies.

12 And on the other side, you've got this crazy,
13 regulated, painful thing called being public. You know,
14 it's a pretty easy choice, right. And so I'll leave
15 that one alone.

16 I promised Lona I'd complain about one more
17 thing before I left, which is this accredited investor.
18 Okay. Time to do that? Just so we can get some
19 specific recommendations.

20 MR. NALLENGARA: Sure, yeah, any -- yeah.

21 More complaining is good.

22 MR. LEZA: With recommendations.
23 MR. NALLENGARA: Yeah, yeah, if you're going
24 to complain, yeah.
25 MR. SUNDLING: Around 506 which -- so the good
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1 news is these reforms around 506 are phenomenal, right.
2 To actually be able to tell somebody that you're selling
3 stock, that's pretty good, right? And we did a PPM and
4 we had to go through all this stuff, and then you get to
5 this notion of accredited investor and who is it. And
6 whatever the -- 200,000 now a year, expecting it for the
7 next year or a million in net assets exclusive of real
8 estate.

9 MR. NALLENGARA: Of your house, your home.

10 MR. SUNDLING: Of your primary residence?

11 MR. NALLENGARA: Yeah.

12 MR. SUNDLING: Okay. So the measurement
13 you're looking for is a sophisticated investor that can
14 evaluate risk, right. I think nobody would argue that
15 just because you have a million bucks in the bank or you
16 make \$200,000 a year doesn't necessarily make you a
17 sophisticated investor. And if there are a lot of
18 people -- you can have a Harvard MBA graduating that's
19 making, you know, 90K doing some analysis work down the
20 road that knows more about your market and your business
21 than anybody else on earth, and you can't take a \$10,000
22 check from him, it just doesn't seem like that's the
23 measurement, right.

24 That maybe these things were thrown out there
25 because somebody needed to -- you had to have some kind
0272

1 of measurement, but what can we do to ease that? Because
2 when you talk about -- someone in here mentioned, I
3 think it was this young man here, cutting off access and
4 limiting investment to certain people. I would argue --

5 MR. GRAHAM: You can still take money from
6 that Harvard professor, you just can't rely on Reg D.

7 MR. SUNDLING: Okay.

8 MS. SMITH: He can be part of your crowd
9 funding.

10 MR. SUNDLING: Yeah. So anyhow, some look at
11 making that a little smarter on identifying what exactly
12 is an accredited investor.

13 MR. GRAHAM: Okay. I want to make sure
14 everyone has a chance to comment before we run out of
15 time. I haven't heard from Karen or Catherine or
16 Kathleen.

17 MS. MOTT: I just wanted to just maybe
18 summarize what I thought when I read all this material
19 and after listening today is that I think there's an
20 amalgam of factors that are contributing to the issues
21 we're dealing with in the marketplace. And obviously
22 things need to be addressed.

23 Where I see critical issues in my industry,

24 because we're at a point where we invest -- we expect
25 VCs to follow on and invest in some of our companies.

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1 And in the two areas are life sciences, biotech, I put
2 them together, and clean tech that are very capital
3 intensive. They're going to require VC money.

4 And when you have a contraction of the
5 industry, what we're seeing is that a lot of these
6 companies aren't getting appropriately funded, and that
7 could really make a difference because there's no
8 incentive, the IPO incentive has been taken away. Or
9 not taken away, but it has diminished.

10 So we have great concerns about when we're
11 making our investment decisions, wow, this is clean
12 tech, maybe we should not invest in this because we
13 don't think we're going to get the follow-on funding
14 that is going to be required for this company.

15 So my concerns, of course, are how much that's
16 going to impact those kinds of companies.

17 And my other concern is something else I'm
18 seeing, is in the M&A market. One of our local
19 companies got 40 million in VC funding, was acquired
20 by -- it was called Renal Solutions. It was a home dialysis
21 kit. Acquired by Fresenius in Germany. Fresenius
22 shelved the company because it was going to disrupt the
23 marketplace. So they paid \$200 million to shelve it. So
24 it didn't create jobs, some people made some money, and
25 it made no difference in the marketplace. So, and it

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1 could have made a difference in people's lives. So
2 that's a concern.

3 My third concern is we can't be sitting here
4 with blinders on and not be concerned about what's
5 happening in China, people with lots of money. And I
6 was at a demo, a demo day in my own little town of
7 Pittsburgh, and there were representatives from China
8 there looking to invest in companies and build these
9 companies. And that surprised me because we're not
10 Boston, we're not Silicon Valley.

11 So let's say they find a Charlie, Charlie's
12 company is going to China. Who's going to create -- the
13 wealth that's going to be created is going to be in
14 China, not here, you know, not in my backyard, if that
15 happens. So those are the kinds of things I'm concerned
16 about if we do not address the IPO market.

17 MR. GRAHAM: Kathleen.

18 MS. MCGOWAN: I just wanted to talk about life
19 sciences and the biotech industry. There are two sides
20 to the story: to stay private and then to look for an
21 M&A transaction. When you're talking about developing
22 drugs, you're talking about clinical trial studies,
23 which could be hundreds of millions dollars. And then
24 you've got a lot of big pharmaceutical companies. And
25 their R&D organizations have been shut down, so

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1 purchasing of -- M&A -- of smaller companies with certain
2 expertise is the way to go and the ability to buy them.

3 So IPOs may not always be an exit. You know,
4 you may not raise all the funds you need to continue
5 clinical trials. It may not be even an exit for the
6 current investors, but, you know, that might be one way
7 of -- one way that's stopping some of the IPOs.

8 But I still think that if you could
9 potentially get an IPO in the market, raise some money,
10 get some big milestones and possibly do a secondary,
11 there's another option of getting additional funds, and
12 then other funding to fund your clinical trials is
13 another option.

14 I think a lot of the JOBS Act will help with
15 reducing some of the required reporting. Because you
16 have to think, some of these small companies have less
17 than 20 people. You can't possibly get all the
18 reporting and all the things up to speed. Yet they
19 still may have a lot of controls in place already to
20 make it, you know, a viable company and to, you know, be
21 reporting similar to what you need to do, which does not
22 have all the head count required and the cost associated
23 with it. Like you said, you know, that money can go
24 into R&D or additional clinical trial, which is to go
25 into reporting.

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1 And then I just had some questions on the
2 tick, the size of the tick, which -- size that David was
3 mentioning in, you know, the pilot program and how do
4 you go ahead and do the piloting.

5 Are the back office operations able to
6 handle -- like if you had two different markets and how
7 you would handle different tick sizes in those markets.
8 Kind of getting the - devil is in the details in how
9 would those things work. Those are things I'm not
10 familiar with. So those would be questions that I have.

11 But basically, you know, you have private
12 markets and potential M&A exit and then IP exit -- IPO
13 exit, what those possibilities were. And if it would
14 help smaller companies get into the IPO market,
15 potentially raise additional funds to do clinical
16 trials, I think that that's well worth the effort. But
17 I still have a lot of questions after everything today
18 on, you know, how do you go about doing that.

19 MR. GRAHAM: Well, the good news is that this
20 committee only has to make recommendations.

21 MS. MCGOWAN: Right. And I don't know a lot
22 of that. Some of the things David brought up, I don't
23 know some of the back office of how you physically do
24 these things. Are they almost more -- you know, I don't
25 know the logistics behind it.

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1 MR. GRAHAM: Right, right.

2 MR. DENNIS: Steven, on that -- at one point
3 we talked about making a recommendation on the high tech
4 companies with very simple operational structures, but
5 large market cap structures. Is that something that
6 we're going to --

7 MR. GRAHAM: I'm sorry. I'm not recalling.

8 MR. DENNIS: Okay. Maybe I'm thinking of a
9 different group or something. But, you know, I think --
10 you know, we've exempted Sarbanes -- we've exempted
11 small companies from Sarbanes-Oxley. And there's this
12 group of companies that are high tech, large market caps
13 and very simple operational structures that are not
14 exempted from SoX 404, and does that make sense to
15 recommend something around that?

16 MR. GRAHAM: I'm not sure if we discussed that
17 in this group, or if it was one of the times I was
18 sleeping.

19 MR. DENNIS: Okay. I'm sorry. I'm brain
20 dead. I must have thought about it -- it must have been
21 somewhere else.

22 MR. GRAHAM: But I do think that one of the
23 things that we have to be thinking about in terms of
24 this recommendation is kind of the way things have
25 played out where now we have -- we have -- you know,

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1 people essentially kind of acknowledge that the scaling
2 can be a good thing. I mean, it's going to make sense
3 in a lot of contexts. And that's given us smaller reporting
companies

4 portion of money. And it's given us the emerging
5 growth company.

6 But, you know, within that are, kind of
7 overlooked, kind of orphans I think in this whole
8 process, are the companies like Chris's company where it
9 doesn't -- it doesn't qualify for any of this stuff. But
10 if she had an IPO with her company and with all the
11 characteristics necessary to qualify as an emerging
12 growth company, she does IPO on December 8, she would
13 qualify for all the benefits. But if she had done an
14 IPO on December 7, she wouldn't.

15 So there's -- not sure how that really kind of
16 plays out in terms of, you know, protection for
17 investors.

18 But I think, you know, certainly a part of
19 this kind of goes back to, you know, kind of the notion,
20 to what extent does it make sense to have, you know,
21 multiple markets? I think that might go to what
22 Kathleen was saying as well.

23 I certainly -- I certainly think that what
24 relief that we have provided for some companies probably
25 could be extended to others. And I also probably made clear that

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1 I think it makes some sense in terms of coming up with
2 kind of another market to operate kind of alongside the

3 markets we currently have in place. Definitely might
4 make things easier.

5 Just conceptually or intuitively, I feel if we
6 had a market and it was geared only to accredited
7 investors and so all the disclosure was simplified
8 accordingly, but nonetheless, who was that you -- you
9 were going to have access to in fact every accredited
10 investor in the world, that you could probably build
11 something. But that's just -- I mean, it seems to me
12 those are -- those are things that we're going to need
13 to explore.

14 Yes.

15 MR. BORER: It's hard to make a recommendation
16 that they should study the fact that we're all really
17 worried about the IPO market being dead and being unfair
18 out there for small companies.

19 One thing I think that makes a lot of sense to
20 some of the stuff that has been talked about today seems
21 to be recommendation that the SEC studies this or it
22 actually looks at regulation can do this as opposed to
23 legislation.

24 But I think making all the companies who are
25 already public subject to similar reporting requirements

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1 that were created in the JOBS Act for that first five
2 years seems like a no-brainer. It absolutely seems like
3 a no-brainer. Why somebody didn't say, hey, why are we
4 putting shackles on these people already because they
5 were dumb enough to already get public and letting these
6 others, you know, run without that problem, that seems
7 like a very easy recommendation. And it's not just
8 because I'm sitting next to Chris.

9 The other thing with respect to -- David is
10 gone now -- Wall Street and the indicting statistic up
11 there today was how many book running managers were
12 there ten years ago versus how many there are today? And
13 it doesn't have anything to do with the fact there's
14 high speed trading taking up the gap. They don't bring
15 companies, you know, public. Morningstar is not
16 bringing companies public. That's just a
17 misunderstanding in the market.

18 If there's anything that can be done to create
19 more H&Qs, Alex Browns, Behrman Sells, Sutros, Adbest,
20 Tucker Anthonys, you know, all these guys, we should try
21 to do it, or else the government is going to have to
22 step in with something like Community Reinvestment Act
23 and say to these big brokerage firms, unless you guys do
24 these 20 small IPOs a year, we're not going to let you
25 do business with the treasury, okay, in the market. And

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1 I don't think that would make sense. It didn't work with
2 big banks, it's not going to work with brokerage.

3 Pick up something specific. If it's tick
4 size, I don't see any downside to it. It may be

5 politically unpopular because people would say, well, if
6 mom and pop investor might by paying another -- you
7 know, a higher commission than they did through -- they
8 are right now through Scottrade. Scottrade at 5.95 isn't
9 giving them any service. It's a wonderful execution
10 platform, but there's no service. And it's dried up the
11 small end of the market, not only for the IPOs, because
12 those firms don't exist anymore to bring them, but also
13 the execution and follow-on.

14 It was -- this morning I think it was David
15 said, he's been on desks, he's run desks. I'm not going
16 to put up \$10 million to take a block of stock because I
17 can't pay 25 cents. I can make 1 cent on the upside and
18 \$2 on the downside as far as per share. It just won't
19 happen.

20 And you can regulate all you want, but if the
21 regulation makes it so that the people you're regulating
22 have no incentive to take the risk unless you force them
23 to take that risk through some mandate, they won't do
24 it, we go home. I think that's what's taking place.

25 So either investigating or actually

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1 implementing something, even if it's on a test or trial
2 basis with this tick size, voluntary or algorithmic or
3 otherwise, it's -- you know, it's a little expression,
4 light one candle, you know, as opposed to cursing the
5 darkness. Because if we just say, let's encourage more
6 small brokerage firms to get in business and see if they
7 do IPOs, we're going to be too old to see the results.
8 It won't happen.

9 So those are two specific things I would
10 suggest we take a look at.

11 MR. GRAHAM: Agreed, agreed.

12 MS. JACOBS: Feel the same?

13 MS. SMITH: I totally agree with everything
14 John said. I think he's spot on.

15 MR. GRAHAM: You got to give us more than
16 that, Karen.

17 MS. SMITH: Well, I --

18 MS. JACOBS: We'll take the I agree.

19 MS. SMITH: No, I appreciate it because, I
20 mean, I've been struggling today with what is our
21 mandate, like what this committee's mandate, now given the
22 changes that happened since we first met around this
23 time last year because the JOBS Act, all the things that
24 have transpired since then. So I appreciate John
25 articulating it in the way he did. I think those are

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1 two very concrete recommendations that we could actually
2 make.

3 MS. GREENE: I'll jump in real quick. I know
4 we're out of time. But I absolutely agree with what he
5 said on both counts. The exemptions and things that
6 were done with the JOBS Act doesn't help me, doesn't

7 help Chris, doesn't help existing companies because we
8 were dumb enough to go public, whatever.

9 So but even more so than saying, okay, take
10 all those exemptions and apply them, let every company
11 take them. Well, but I want them longer than five years
12 if I can't get my market cap or my revenue or my assets
13 or whatever up over some amount.

14 So as Chris said at the beginning where that
15 75 million market cap, which I really appreciate right
16 now, because we're under that, but if we crowd -- if we
17 get close to that number, my incentive to stay under
18 that market cap is going to be really high, which works
19 totally against investors, because I don't want to do
20 404(b). I don't want to do all those things.

21 So, as Chris said, where 75 million dollar market
22 cap came from as far as exemptions or small
23 reporting companies, I think that needs to be --
24 certainly needs to be increased. Whoever said the
25 market cap \$787 million is 94 percent of the total

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1 public company value, and so everybody under -- you know
2 how far away a \$787 million market cap is for us? It
3 will never happen in the lifetime of me and the next ten
4 generations, I suspect. So, but that's only 6 percent
5 of the total public company value. And we're -- you
6 know, we help the little companies under 75 million.

7 So I will jump out there and say I like what
8 John said, but I would make that -- those small company
9 exemptions -- set the market cap so if I still don't hit
10 whatever the market cap is in five years, I don't fall
11 off that exemption thing and go, oh, now you're there.
12 So -- based on what Chris said.

13 Some of the things that Charlie said, and
14 these are just -- I wrote them down so I wouldn't ramble
15 too much. So there is no -- as Charlie said, the
16 perception of being public, there's no payoff for that for a
17 small company. Whether that's reality or not, that's the
18 perception. And I don't hear any small public companies
19 talking about how great it is to be public, because
20 there is no -- there's no payoff.

21 Making the IPO process -- and I don't know
22 which one of you guys said it -- making it more
23 attractive doesn't solve the lack of post IPO support
24 for small companies. So you go out and, you know, you
25 do this great IPO, but if you're not -- if you're not

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1 the billion dollars or whatever, there's no money in it
2 for the guys that actually used to provide that
3 support -- that support in terms of research and
4 investment banks and whatever.

5 I can't tell you how many investment banks I
6 talked to. I have no deal for you. Well, they're not
7 going to make -- I mean, we trade 5,000 shares a day.
8 They're not going to go for that. I mean, there's

9 nothing -- there's nothing that our company's doing that
10 would incentivize anybody to put any support in, make
11 the phone calls to the brokers, whoever said all that.
12 There's no money there.

13 So until there's money there, and maybe that's
14 tick size, until there's some financial incentive for
15 those guys that used to support public companies,
16 small public companies -- until there's some financial incentive, I
don't

17 think -- I don't think anything is ever going to be
18 solved. Companies are not going to go public because
19 they can't get the aftermarket support. Nobody in --
20 out of the goodness of their heart is going to spend a
21 bunch of time trying to support very small companies,
22 because we're all in everything we do to make money.

23 So I think -- I think tick size is the most
24 concrete suggestion I've heard. And I don't understand
25 it exactly either. I don't know -- if you came to me

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1 and said, what do you think your tick size is? I don't
2 know. But why not try it? I mean, it can't get any
3 worse, right? I mean, for us it can't get any worse.
4 For Chris, it probably can't get worse. So why not try
5 it. It's a concrete suggestion. Let's -- why not throw
6 it out there.

7 Investor interest, it is about increasing
8 shareholder value, which is increasing stock price. That
9 is the result of earnings and growth. Cost to be
10 public, million dollars, whatever. You take that out of
11 your earnings, the pressure on earnings to continue to
12 grow in order to increase your shareholder value, in order
13 to keep investors interested, it's very circular. And
14 the more money you spend on stuff, cost to being public,
15 whatever, reduces earnings. If you're not growing
16 earnings, then the investors aren't interested in you.
17 Again, they're in it to make money, they're not in it
18 because they're feeling generous today.

19 SarbOx, somebody said, had a very small
20 impact. I adamantly disagree with that. But that may
21 be perception now more than anything. SarbOx, the
22 idea why public companies don't -- or why private
23 companies don't want to go public. SarbOx is a huge
24 issue. And whether that's reality or not, the
25 perception is it's a huge issue. I don't want to deal

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1 with the SarbOx stuff, so --

2 And then even if the original reason for
3 wanting to go public is to raise capital, don't we all
4 want to get -- and I throw this out. I'm tired and
5 maybe this doesn't make sense. But don't we all want to
6 get to where we don't need to raise money? I mean,
7 don't we want to grow our companies to where they're
8 organically growing to support or growing enough that we
9 can support our growth internally with organic cash flow

10 and all that, as opposed to having to go back out to the market
11 to garner more -- to raise more capital?

12 So capital formation may be -- or capital
13 raising may be a viable reason to go public to start
14 with. But I know, in my mind, I would eventually want
15 to outgrow that anyway. Once you outgrow that and you
16 don't need to raise money, as Richard said, we have so
17 much cash on the balance sheet, then you have no deal
18 for anybody to do anything for you, so, you know, again
19 it's circular. There's no support.

20 MS. JACOBS: So then why go public?

21 MS. GREENE: Yeah. I mean --

22 MS. JACOBS: You can't get out, you're going to get sued -

-

23 MS. GREENE: Or you're going to leverage your
24 company so bad to get out that -- yeah. So
25 recommendation is raise the \$75 million market cap on

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1 small reporting companies up to -- I don't know, I mean,
2 787 million sounds like a great number, but, you know,
3 I'll take 500 million or whatever. I think that's a
4 great recommendation.

5 Tick size. The only concrete thing, I mean,
6 that I've really heard that might help the aftermarket
7 support for those people that can actually do something
8 with your stock, the market makers and the traders and
9 all that, why not recommend that and see what the SEC
10 comes up with?

11 MS. JACOBS: Any other -- any discussion
12 around the 787 million market cap?

13 DR. RITTER: I've got a catchy acronym. We
14 call it the "BOEING" amendment.

15 MR. DENNIS: The problem with -- if you go up
16 to 787 million, and I'm trying to remember the
17 statistics we looked back four, five years ago, Gerry.
18 But the 75 million, I believe, came from, it was 1
19 percent of the market cap, is where that -- I thought
20 that's where we kinda came up with that recommendation.
21 Because it was 25 million at one point. The 787
22 million, although it's 6 percent of the market cap, it's
23 something like 80 percent of the number of public
24 companies.

25 So if you exempt 80 percent of the public

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1 companies out there from Sarbanes-Oxley, and you've kind
2 of done an end run around Congress and the law, and I think
3 you get -- I think it's easy to say. I think it's hard
4 to go down and say, Congress adopted a law that said
5 public companies have to do this and the SEC is going to
6 exempt 80 percent of the public companies out there.

7 MS. GREENE: Well, I think lower the number,
8 then. Go to, I don't know, go to 75 million.

9 MR. LEZA: Go to 250 million, like I said
10 before.

11 MR. DENNIS: I'm just saying it's harder than
12 just that. But --

13 MS. JACOBS: Right. But the law -- but
14 Congress itself has exempted companies up to a billion
15 in revenue, which I don't consider emerging, but that's
16 how they've identified them.

17 MR. DENNIS: First five years of their
18 existence, right.

19 MS. JACOBS: That's right.

20 MR. GRAHAM: Yeah.

21 MS. JACOBS: Yeah.

22 MR. GRAHAM: So you've raised a very good
23 point. And I think that one of the reasons why we
24 frequently have issues is that people kinda don't
25 normally -- they're really unable to foresee the

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1 unforeseen consequences. And I think that's one of the
2 things that I want to make sure that we do as a
3 committee, make recommendations, perhaps raise certain
4 issues that were raised.

5 We are past time to -- wrap things up. Has
6 everyone had a chance to comment?

7 (No audible response.)

8 MR. GRAHAM: What I would like to -- I've
9 heard -- again, there are a number of things that we
10 talked about. And I think that there is -- the seeds
11 have been planted, I think, for a number of
12 recommendations. Certainly there are two or three things
13 that are relatively concrete on the table. And that is
14 the tick size. One has to do with expanding the -- expanding
15 the relief that was provided under the JOBS Act for a
16 broader group of small public companies, which just
17 happen to have gone public before December 8 and -- am I
18 missing one?

19 MR. DENNIS: Conflict minerals. Let's put
20 conflict minerals. I mean, I'd put it on just because I
21 think conflict --

22 MS. JACOBS: I don't think we have a thing to
23 lose.

24 MR. DENNIS: Well, I think Congress doesn't
25 read these reports.

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1 MS. JACOBS: Yes, no.

2 MR. GRAHAM: We'll make recommendations to the
3 SEC, so I'm not sure.

4 MR. DENNIS: I don't know how we word it,
5 but --

6 MR. GRAHAM: I'm not sure if our mandate says
7 to do that.

8 MS. JACOBS: But I think we can go on record
9 as recommending --

10 (Talking simultaneously.)

11 MR. GRAHAM: (Inaudible.)

12 MS. JACOBS: -- an exemption.

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PROOFREADER'S CERTIFICATE

In The Matter of: MEETING OF SEC ADVISORY COMMITTEE ON
SMALL AND EMERGING COMPANIES
File Number: OS-265-27
Date: Friday, September 7, 2012
Location: San Francisco, CA

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(the undersigned), do hereby swear and affirm that the
attached proceedings before the U.S. Securities and
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accurate transcript that has been compared to the
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File Number: OS-265-27

9

Date: Friday, September 7, 2012

10

Location: San Francisco, CA

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12

This is a letter to inform you that we do not release
13 our tapes and notes. I do maintain them for a period of
14 one (1) year.

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Sincerely,

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