

THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

ADVISORY COMMITTEE ON SMALL AND EMERGING COMPANIES
MEETING

Wednesday, September 13, 2017

9:39 a.m.

Multi-Purpose Room LL-006

100 F Street, N.E.

Washington D.C.

Diversified Reporting Services, Inc.

(202) 467-9200

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1 APPEARANCES:

2 Stephen M. Graham, Advisory Committee Co-Chair

3 Sara Hanks, Advisory Committee Co-Chair

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5 Current Members of the Advisory Committee:

6 Robert Aguilar

7 Xavier Gutierrez

8 Brian Hahn

9 Catherine V. Mott

10 Jonathan Nelson

11 Patrick Reardon

12 Lisa Shimkat

13 Annemarie Tierney

14 Gregory C. Yadley

15 Laura Yamanaka

16 J. W. Verret (Appointed June 1, 2017)

17

18 Non-Voting Members:

19 Michael Pieciak

20 Joseph Shepard (appointed May 9, 2017)

21

22 Other Securities and Exchange Commission Staff:

23 Michael S. Piwowar, Commissioner

24 Jay Clayton, SEC Chairman

25 William H. Hinman, Director of Corporate Finance

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1 A G E N D A

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3 9:30 a.m. Co-Chairs Call Meeting to Order

4 Introductory Remarks by Chairman Clayton &

5 Commissioner Piwowar

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7 10:00 a.m. Auditor Attestation Report under Section

8 404(b) of the Sarbanes-Oxley Act

9 Presentations:

10 Leonard L. Combs, PwC, U.S. Chief Auditor

11 William J. Newell, Chief Executive

12 Officer, Sutro Biopharma, Inc.

13 Committee Discussion

14 11:30 a.m. Final Report of the Advisory Committee to

15 the Commission

16 Discussion and Vote on Adoption

17 12:30 p.m. Lunch Break

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1 APPEARANCES, CONT:

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3 Other Securities and Exchange Commission Staff(cont.):

4 Robert Evans, Deputy of Legal and Regulatory Policy

5 Elizabeth Murphy, Associate Director

6 Sebastian Gomez Abero, Chief, Office of Small

7 Business Policy, Division of Corporate Finance

8 Julie Z. Davis, Senior Special Counsel

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1 A G E N D A (CONT.)

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3 2:00 p.m. Awards Pursuant to Written Compensatory

4 Benefits Plans - Should Securities Act

5 Rule 701 Be Updated?

6 Presentation:

7 Christine McCarthy, Partner, Compensation

8 Benefits, Technology Companies Group,

9 Orrick

10 Steve Miller, Chief Financial

11 Officer, Warby Parker

12 Committee Discussion

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14 3:30 p.m. Adjournment

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PROCEEDINGS

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2 CO-CHAIR GRAHAM: Could I get people to take
3 their seats? Well, welcome everyone. Good to see you
4 all. Sebastian, I believe we have a quorum.
5 MR. GOMEZ ABERO: We do.
6 CO-CHAIR GRAHAM: Okay. As you know, the two-
7 year term of this Committee's charter expires September
8 24, so this will be our last meeting. We have drafted a
9 final report to memorialize the recommendations made by
10 the three iterations of this Committee over the past six
11 years, and just as importantly, to identify areas we
12 recommend for continued focus. We will take up that
13 report later this morning.
14 Our first item of business this morning will be
15 the Auditor Attestation Required by SOX 404(B). This is
16 a topic we have touched on previously and today, I hope
17 we can get into it in more depth. This afternoon, we'll
18 discuss Securities Act Rule 701, an exemption that many
19 companies use to grant options and other equity-based
20 compensation. The ability to attract and retain talent
21 by giving employees and other key people a stake in the
22 business is critical for emerging businesses. As
23 companies are staying private longer, it is important to
24 take a look at this rule to see if modernizing amendments
25 might be in order.

1 We have a new member to introduce, J.W. Verret,
2 is J.W. here? Hello, sir. Welcome. J.W. is an
3 associate professor at Antonin Scalia Law School, which
4 is at George Mason University. He's also a senior
5 scholar at the Mercado Center Working Group on the
6 Financial Markets. It's a little bit like being drafted
7 on the last day of the war, but it's (laughter) -- before
8 we move further into our agenda for the day, we are very
9 pleased to have Chairman Clayton and Commissioner -- not
10 yet Commissioner Piwowar. He's --
11 MR. GOMEZ ABERO: He's trying to avoid the
12 draft.
13 CO-CHAIR GRAHAM: So I will then turn it over
14 to our Chairman.
15 CHAIRMAN CLAYTON: Thank you, Steve and Sara
16 and all of the members of the Committee. Good morning.
17 I'd also like to join Steve in extending a warm welcome
18 to J.W. And as Steve noted, the two-year term of this
19 Committee expires on September 24th. I want to extend my
20 sincere appreciation to all of you for your dedication in
21 service. Your recommendations have been and will
22 continue to be helpful as we work to facilitate the
23 ability of small and emerging companies to raise capital.
24 In my short time here, I've already come to
25 appreciate the insights and expertise that this Committee

1 brings to bear. I'm going to deviate a bit from my
2 prepared remarks and just say the perspectives that we
3 hear from you and your real world perspectives and
4 others, matter a lot. We recently traveled to St. Louis
5 and did a roundtable with what I call Main Street
6 investors. Having their perspectives in mind as we craft
7 investor protection rules is very important. Yesterday,
8 we had a VC group in here and where's Raquel? Raquel
9 said you have to come in and hear this, you know, the
10 state was that the Midwest is somewhere between the 5th
11 and 10th largest economy in the world.
12 Over 100 Fortune 500 companies, but only four
13 percent of US venture funds. Doesn't make sense that you
14 would have that robust an economy and so few people
15 looking toward the future. And we should have that in
16 mind as we think about some of the issues that we're
17 going to talk about today.
18 So it matters to hear from you, and let me go
19 back to my prepared remarks. I don't think -- Bill, I
20 don't think I had a material, you know -- I don't -- I
21 don't think there'll be a material omission as a result
22 of those comments.
23 MR. HINMAN: We'll review it. (Laughter)
24 CHAIRMAN CLAYTON: Well, thank you. This
25 Committee has long been recognized and appreciated, so

1 much so that Congress recently codified the Committee
2 into the Exchange Act. I'm pleased to announce that the
3 Commission is moving forward on establishing this
4 permanent successor Committee, which will be named The
5 Small Business Capital Formation Advisory Committee. I
6 am thankful, and you and others have served in this
7 Committee should be proud that the thoughtful dialogue
8 and recommendations that you have had have led Congress
9 to take this action.
10 Along those same lines, today, we published a
11 nationwide job search for the new advocate position. I
12 think the timing is good. It should've hit the wires,
13 and we look forward to getting that person onboard. If
14 you have people you want to nominate, nominate them. We
15 want to -- we want to have a robust applicant pool.
16 So today's agenda, Steve covered it well. It's
17 clear that you guys are not slowing down. You're
18 exploring two very important areas for small and emerging
19 companies, and I look forward to hearing your views.
20 You'll take up the discussion of 404(B). Here, I
21 want to note that we recently proposed amendments that
22 would increase the financial thresholds for smaller
23 reporting companies and thereby expand the number of
24 companies that could qualify for scaled disclosures.
25 We've received a number of thoughtful comments

1 on this proposal and we look forward to hearing your
2 discussion and, as always, any data and experience you
3 can share. This afternoon, we'll include a discussion of
4 potential updates to modernize Rule 701, which is an
5 exemption from registration for securities issued by non-
6 reporting companies pursuant to compensation
7 arrangements. In essence, it's a rule that makes it less
8 burdensome to compensate employees with equity.

9 The Commission last adopted substantive
10 amendments to this rule in 1999. Since that time, many
11 companies have chosen to stay private longer and have
12 higher valuations and our markets have changed in other
13 ways. In light of these developments and recent
14 legislative efforts related to this rule, including
15 yesterday, I'm interested to hear whether this Committee
16 believes Rule 701 continues to appropriately serve both
17 the needs of employee investors who receive compensatory
18 awards and the needs of non-reporting companies.

19 I also look forward to reading the Committee's
20 final report that you are discussing today, as the
21 Commission explores ways to improve the attractiveness of
22 being a publicly listed company while maintaining
23 important investor protections. Your recommendations
24 will continue to be instrumental. I'm going to slow down
25 here. (Laughter) Your timing is perfect.

1 MALE SPEAKER: That's right.

2 CHAIRMAN CLAYTON: You're always perfect.
3 You're always perfect. Thank you, again, for your
4 service to this valuable Committee, and I hope you enjoy
5 a productive day. Right on time.

6 COMMISSIONER PIWOWAR: My turn?

7 CHAIRMAN CLAYTON: Yes.

8 COMMISSIONER PIWOWAR: Man, I don't even get to
9 rest. I just sit down and go ahead and speak. So good
10 morning and warm welcome to everyone on the Committee,
11 including our newest member of the Committee, Professor
12 J.W. Verret, a good friend of mine from George Mason
13 University's Antonin Scalia Law School.

14 Today, we bid a fond farewell actually to the
15 Committee, which is convening for the 22nd by my count
16 and final time.

17 CO-CHAIR GRAHAM: Yes.

18 COMMISSIONER PIWOWAR: 22nd or 23rd. I think
19 we've met 22 times.

20 MR. GOMEZ ABERO: It depends on whether you
21 count the telephone meetings as well or not. (Laughter)

22 COMMISSIONER PIWOWAR: No.

23 MALE SPEAKER: We're not going to have --

24 COMMISSIONER PIWOWAR: If you count those,
25 we're at like 150, I think.

1 MALE SPEAKER: -- we're not going to have a 404
2 attestation on that today. (Laughter)

3 COMMISSIONER PIWOWAR: You're close enough,
4 that's good. So since your first meeting, I believe it
5 was on Halloween 2011, you've enlivened policy discussion
6 and debate within our agency, and you've produced
7 numerous recommendations, each of which, whether adopted
8 or not, has informed and sharpened the Commission's
9 analysis of its mission with respect to small and
10 emerging companies. I'd like to take this opportunity to
11 commend the members of this Committee for the service
12 that some of you have rendered for the entire six years
13 and for -- and for a number of you, for a good portion of
14 that time.

15 It has long been remarked that we Americans
16 distinguish ourselves by our willingness to participate
17 in voluntary organizations dedicated to the common good.

18 As Alexis de' Tocqueville, famously remarked,
19 "Americans of all ages, all conditions and all
20 dispositions constantly form associations. Wherever the
21 head of some -- at the head of some new undertaking, you
22 see the government in France, a man of rank in England,
23 and in the United States, you'll be sure to find an
24 association," or Committee.

25 In attending these quarterly meetings of your

1 association and your monthly conference calls, in
2 drafting and revising the text of your many
3 recommendations, in putting aside faction in the interest
4 of civic duty, you have acted in the very highest
5 motives. You have provided invaluable service to our
6 country without prospect of fame or fortune.

7 You have marshalled your expertise to the -- to
8 benefit entrepreneurs and innovators who may never know
9 the service you've done them but whose future successes
10 will contribute to the flourishing of our country.

11 As Chairman Clayton just announced -- I hope
12 you just announced before I walked in, the SEC is
13 launching a nationwide search to hire the Agency's first
14 ever advocate for small business capital formation. By
15 statute, the appicate must be chosen from outside the
16 ranks of current SEC employees and I hope that you all --
17 you all will encourage strong candidates to apply for the
18 position. I hope, too, that I will continue to see some
19 of the faces gathered here on the new Small Business
20 Capital Formation Advisory Committee whose establishment
21 lies in the not too distant future.

22 And in closing, as Edmund Burke wrote, "To be
23 attached to the subdivision, to love the little platoon
24 we belong to in society is the first principle of public
25 affections. It is the first link in the series by which

1 we proceed towards a love of our country and to
2 mankind." At the risk of sounding a little sentimental,
3 this Committee, your little platoon has been the vehicle
4 by which you have shown both your patriotism and your
5 professionalism. On behalf of my fellow commissioners,
6 past and present, I thank you for your service and I look
7 forward to your continued contributions in the years to
8 come. Thank you all.

9 CO-CHAIR GRAHAM: Thank you, Commissioner. I
10 should say that Commissioner Stein would like to be here.
11 She's travelling. She sends her regrets.

12 We want to briefly acknowledge the SEC Staff at
13 the table from the Division of Corporation Finance, and
14 so I'd like to turn it over to their leader, Bill Hinman,
15 who will introduce the others.

16 MR. HINMAN: Sure thing. Thank you, Steve and
17 Sara for your leadership of the Committee and your work
18 on the Committee. It's been very valuable. I regret
19 that this is the only meeting I will be able to attend,
20 my first or last, but with my staff, I've heard a lot
21 about the work you've done and have been very impressed
22 and very thankful for the efforts you all made. And
23 thank you, again, for your service. Let me echo that.

24 Unfortunately, I won't be able to stay with you
25 very long today. I am actually traveling to some other

1 groups to meet with some other groups, the Council of
2 Institutional Investors in California and the American
3 Bar Association Business Group in Chicago on the way
4 back. As part of our effort to get input from a wide
5 range of constituents and interested parties and, as has
6 been mentioned, that input from groups like this and
7 others is extremely valuable to us. So the topics you
8 have today are right in our wheelhouse. We've been
9 having meetings on a number of the things that you'll be
10 covering today and I'm looking forward to hearing part of
11 it and reading some other reports that you've generated
12 so thank you for that work.

13 Let me acknowledge our staff that are here
14 today. You know many of them and have worked with them,
15 but we do have one new member, Rob Evans, our new deputy
16 of Legal and Regulatory Policy. On my right, I think you
17 all know Betsy Murphy, one of our associate directors,
18 who has oversight of the Small and Business Policy
19 Office. The head of that office, Sebastian Gomez Abero,
20 who I know you all think fondly of, and I know he has
21 enjoyed his work with this Committee and has spoken
22 highly about that to me.

23 And finally, Julie Davis here, our senior
24 special counsel in that office. Again, someone I'm sure
25 you know well. I don't want to have any material

1 omissions, so let me say the standard disclaimer, the
2 folks on the staff that will speak today are giving their
3 own views, not those of the Commission or any other
4 members of the staff. And with that, let's kick it off.
5 Thank you.

6 CO-CHAIR GRAHAM: All right. Thank you, Bill.
7 And on behalf of the Committee, I, too, would like to
8 thank the staff for their tireless efforts. It's -- we
9 do respect your work and it is much appreciated.

10 (Applause)
11 So let's go to 404(B), and with that, it's all
12 yours.

13 CO-CHAIR HANKS: All right. Are we going to
14 bring up our witnesses? Speakers -- witnesses
15 (laughter). This is just too Washington sometimes.
16 Thank you speakers.

17 As Chairman Clayton mentioned earlier, in June,
18 the Commission proposed amendments to increase the public
19 float threshold. That's the threshold at which companies
20 can qualify to provide scaled disclosures, smaller
21 reporting companies. That proposal would raise the
22 threshold in the definition from \$75 million to \$250
23 million, and that is something that this Committee has
24 been very much in favor of. The release discussed
25 but did not propose to similarly raise the current \$75

1 million threshold, at which a registrant's auditor must
2 attest to and report on management's assessment of a
3 company's internal controls. Now, this is an incredibly
4 important thing. Financial statements are, of course,
5 the essence of company disclosure, but it's also
6 something that is pretty burdensome at times and those of
7 us, as the Chairman mentioned, with real life experience
8 have come across this.

9 This auditor attestation requirement of
10 Sarbanes Oxley 404(B), SOX 404, is something we've
11 discussed previously. It's one of the requirements from
12 which the emerging growth companies are exempt for a
13 five-year onramp, pursuant to the Jobs Act. The release
14 asked for comments and data on several alternatives. One
15 of which would be to extend the SOX 404(B) exemption to
16 all registrants that are eligible for and claim reporting
17 company status. In keeping with this Committee's
18 continuing and everlasting thirst for quantitative data,
19 we wanted to look into the costs that smaller companies
20 incur in complying with SOX 404(B), so we've brought in
21 some additional expertise. First, I'd like to introduce
22 Leonard L. Combs, PwC's US Chief Auditor.

23 Len has more than 25 years of public accounting
24 experience and now oversees PwC's audit policies and
25 practices. Before joining PwC's national office, he led

1 their pharmaceutical life science and technology practice
2 in Philadelphia. He is also a member of the PCAOB's
3 standing advisory group.

4 Next to Len is William J. Newell, Chief
5 Executive Officer of Sutro Biopharma Inc. Located in San
6 Francisco, Sutra is a private company that discovers and
7 develops cancer therapeutics. Prior to joining Sutra in
8 2009, Bill had years of senior management experience with
9 established publically traded firms in the biotech
10 industry and prior to that, he practiced law for 16
11 years. He's also a board member on the trade association
12 bios, emerging companies section. We appreciate very
13 much having both of you here today and to help us delve
14 into this important topic. Please take it away.

15 MR. COMBS: So thanks, Sara, for the
16 introduction, and thanks for the opportunity to come and
17 share our perspectives. I was asked to come to talk
18 about the evolution of the audit of internal controls
19 under 404(B), as well as as auditors, how do we think
20 about going about doing that audit, and then certainly,
21 give our perspectives on the benefits. Certainly over
22 the past, you know, 10 to 15 years, Sarbanes Oxley and
23 the application thereof has evolved. We've certainly
24 seen many of the benefits of those, broadly speaking, so
25 greater accountability on behalf of management and the

1 there's no obligation or requirement on behalf of the
2 auditors to audit internal controls based on, you know,
3 the current requirements. Certainly some of that
4 importantly was driven by the Jobs Act, and I think
5 Bill's going to talk about that fact that, you know, many
6 of the companies that filed under the Jobs Act are now
7 coming to the end of -- end of that horizon and
8 timeframe, so important considerations to think about.

9 So if we go back and talk about the history a
10 little bit of 404(B), certainly, you know, when auditors
11 and management teams first had to assert to the
12 effectiveness of controls and then auditors had to attest
13 to the effectiveness of controls back in 2004, the cost
14 and the changes were significant, no denying that. As
15 time has progressed, I do believe, you know, management -
16 - I do believe auditors have gotten better at doing
17 control audits and understanding their control
18 environments and certainly doing better risk assessments
19 and importantly integrating, you know, the audits between
20 a financial statement audit and the audit of internal
21 controls.

22 The SEC and the PCAOB, as I talked about,
23 undertook some important rule-making that came to
24 fruition in 2007, which I'll talk about in a little bit -
25 - in a little bit more detail, but really focused on

1 auditors, improved transparency and certainly the trend
2 on restatements is certainly encouraging as the quality
3 of financial reporting and auditing has improved over a
4 number of years.

5 You know, that being said, there is a cost of
6 being a public company, right? Whether it's, you know,
7 higher director fees, higher fees paid to management,
8 external auditors, legal costs, you know, so I certainly
9 acknowledge, you know, that this needs to be carefully
10 considered as we, you know, think about regulating and
11 absolutely recognize there is a cost of this, including
12 the cost of doing 404(B), so that's kind of undeniable.

13 So then, we'll go into talking about how we
14 think about it, our perspectives on how we do that audit,
15 what's changed from the standpoint of SEC regulation,
16 PCAOB regulation and some other helpful guidance that's
17 been issued over a number of years and the benefit that
18 that's provided.

19 So just to, you know, level set with everyone,
20 and I know Bill's going to talk about some of the
21 criteria of how, you know, you fall out of the non-
22 accelerated filer status and, therefore, require a 404(B)
23 audit to be done by your auditors, but as we think about
24 the population, right now, about 50 percent of all public
25 companies have non-accelerated filer status, meaning

1 right sizing the amount of work that management had to
2 do, as well as right sizing the amount of work that
3 auditors needed to do in order to opine on internal
4 controls and certainly for a second time, we did see a
5 fairly significant decline in the cost of auditors doing
6 the audits as well as the cost of the -- the internal
7 cost management faced and the cost that they were paying
8 third parties, you know, to comply -- help auditors
9 comply with the requirements of 404(B).

10 So the end results of those efforts were, you
11 know, an integrated audit whereby we believe, at this
12 point in time, the incremental cost of doing a 404(B)
13 audit in the context of the overall -- the integrated
14 audit is certainly a fraction of what the overall cost
15 doing the audit -- said another way, you know, we don't
16 think this is a one-plus-one equals two, when you think
17 about the cost of doing a 404(B) audit, but again, the
18 incremental cost relating to solely auditing internal
19 controls is a fraction of the overall cost and certainly,
20 and importantly, that does vary by size of company, so
21 you know, for much larger, much more complex companies,
22 it's probably a smaller percentage of the overall cost,
23 too -- and -- but as you go down the curve and you get to
24 a smaller sized company, the percentage of those fees are
25 probably -- certainly probably a bit higher.

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1 So on this next slide, and I'm not going to
 2 take you through the gory detail of this, but the SEC and
 3 the PCAOB, you know, did focus on important reforms that
 4 we believe are helpful. The punchline of this is we do
 5 believe the revisions to the requirements did really
 6 drive scalability of the audit, allowed much more
 7 flexibility and judgement on behalf of management, you
 8 know, and the auditors. It drove importantly the ability
 9 for both to really focus on the risk assessment and focus
 10 on those areas that were most likely to result in, you
 11 know, potential material misstatements to the financial
 12 statements. So as I said again, as a result of the
 13 efforts in 2007, again, an important decline in the
 14 overall cost of compliance.

15 So let me briefly turn to talk about what we do
 16 in an audit, both a financial statement and audit and an
 17 integrated audit, which includes auditing internal
 18 controls under 404(B). And my intent here today is
 19 certainly not to make you experts in auditing, we'd be
 20 here for a while, but rather to really demonstrate and
 21 discuss how many of the procedures that we do for a
 22 404(B) audit are consistent with what the requirements
 23 are for a financial statement audit. And they really
 24 piggyback off each other. So when we think about
 25 planning the audit, the way we establish materiality and

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1 those things we're going to focus on is the same between
 2 the financial statement audit and an audit of internal
 3 controls.

4 Our risk assessment procedures, where we really
 5 try to understand the company, its environment,
 6 understanding the processes and controls that are in
 7 place, which we need to do, whether we do an integrated
 8 audit or we do a financial statement only audit so that
 9 doesn't change, as well as the other overall risk
 10 assessment and planning the audit really is the same
 11 between, you know, both audits as we go through it.

12 When we think about what are those things we
 13 need to audit, so significant accounts from either a
 14 financial statement or audit or internal controls audit,
 15 they are the same between the two. And this is really
 16 where scalability starts coming in, to the extent that
 17 something's not, you know, applicable to -- for example,
 18 a precommercial entity, certainly we're not going to look
 19 for controls over, you know, revenue and audit controls
 20 over revenue when we're in -- when a company's in a
 21 precommercial stage. So that really, you know, for both
 22 financial statement and integrated audit, allows us to
 23 really scale the audit, determine what we need to do
 24 based on the risk presented by a specific company --
 25 within a specific company.

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1 So again, not to go into the gory detail, but
 2 when we think about the audit of ICFR, we certainly
 3 identify the controls that are relevant to the risks
 4 presented in the financial statements. And I think we
 5 went -- we went blank up there. I'm not sure what -- so
 6 it focuses on those risks that are relevant to that
 7 particular company and what could represent a material
 8 misstatement if those controls don't operate effectively.

9

10 We think about it from a top-down standpoint
 11 and certainly design our audit opinion based on that.
 12 You know, in many cases, whether it's a audit of internal
 13 controls or solely a financial statement audit, we will
 14 look to audit the controls anyway because if we assess
 15 the design of the controls and we determine those
 16 controls to be effective and we can test those, often, we
 17 can think about reducing the amount of work that we do on
 18 the financial statement audit.

19 So then this really gets to the point about
 20 integrating the audits to the extent that we look at the
 21 controls, they're effective; they're working. That
 22 allows us, under the professional standards to really
 23 reduce the amount of work we're doing on the financial
 24 statement audit. And this is an area that I think over
 25 the past 10 years, you know, we've really taken a step

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1 forward as a profession, really trying to make sure that
 2 we've integrated, you know, both of those activities and
 3 not think about them as two separate audits.

4 So after we think about, you know, internal
 5 controls, we then do think about what's the balance of
 6 the work we need to do to get comfortable with the
 7 financial statements and making sure that my financial
 8 statements are materially stated, are reasonably stated
 9 in all material respects.

10 Again, we think about the nature and timing,
 11 extent of the work we do. Based on the control comfort
 12 we get, we can certainly vary our plan substantive work
 13 and the evidence we need to obtain based on the
 14 effectiveness of the controls. And then we evaluate the
 15 overall results of the work, both from an internal
 16 controls standpoint, think about the reporting
 17 considerations related to those; we think about the
 18 results from a financial statement standpoint and the
 19 related reporting implications and move to, you know,
 20 opining on both the controls and the financial
 21 statements.

22 So obviously, at a very high level, the two
 23 points I wanted you to take from that is the two
 24 processes of auditing and signing the two opinions, one
 25 on the financial statements and two on the controls, are

1 very integrated at this point. And the level of work and
2 the level of comfort you get on one certainly drives the
3 level of work and comfort you get on the other. The
4 other thing I would -- I would just add that I want you
5 to take away is many of the things you need to do for an
6 audit under 404(B) are similar, if not the same, to what
7 you need to do under a financial statement audit. So
8 making sure those work together in harmony is crucially
9 important to making sure that we do, you know, both an
10 effective as well as efficient audit.

11 So the last thing in my prepared remarks I'll
12 just talk about is our perception of the key benefits of
13 404(B). You know, certainly what we hear in where we
14 travel when we meet with investors, we hear that there's
15 certainly value in a controls audit, in the transparency
16 that provides around the effectiveness of controls. I
17 think in this day and age, investors are asking for more
18 transparency versus less transparency, certainly we see
19 that with the PCAOB's proposed standard that's currently
20 in front of the SEC regarding the new auditor reporting
21 model and the fact that, you know, investors view that as
22 being important to start to eliminate some of the
23 information asymmetry that exists between, you know,
24 auditors and management and investors.

25 We've certainly seen that over time, as

1 viewed as beneficial and the fact that financial
2 reporting is more reliable when the auditors are actually
3 involved in the assessment of ICFR. GAO found that
4 companies exempt from 404 have more restatements, as
5 we've talked about, and there are other benefits. In
6 fact, you know, many of the companies interviewed in the
7 GAO study said there was a lot of benefits, including
8 ancillary benefits in the context of 404(B).

9 There's been a lot of studies done, academic
10 studies done on the benefits of 404(B) and certainly not
11 going to go through all of them, but one of the other
12 benefits that some of the studies point out, and I just
13 have one observation -- one study and one observation
14 here, is companies that do have a 404(B) opinion that's
15 issued by their auditor actually experience higher
16 valuation premiums and as well as lower cost of debt. So
17 there's a lot of academic research out there that also
18 supports the fact that the benefits are certainly
19 important.

20 So, you know, obviously, there's two sides to
21 every coin. That's one perspective. We certainly do
22 recognize that, as I said at the beginning, there's a
23 cost associated with this. You know, I particularly have
24 a level of understanding coming from the bio and pharma
25 space that, you know, when you're precommercial, in

1 companies, as auditors become more familiar with how to
2 audit internal controls, the costs have certainly come
3 down and, importantly, I think the contributions of the
4 SEC and the PCAOB in that area were important. From my
5 perspective and from the firm's perspective, we certainly
6 think that compared to, you know, pre-404, financial
7 reporting is certainly more reliable than it was,
8 certainly provides more accountability, both on behalf of
9 management, as well as the auditor. From a, you know,
10 data standpoint, the restatements of non-accelerated
11 filers have always been higher than accelerated filers,
12 so that is, you know, data that is out there to support
13 the continued benefit of 404(B) audits and what that
14 requires.

15 And we also notice that rates at which
16 companies have ineffective ICFR continues to be, you
17 know, noticeably higher for companies with smaller market
18 cap versus larger market cap and the analysis that we've
19 done using external data, it's typically, you know, twice
20 as high when we think about that.

21 You know, obviously, there was also analysis
22 and studies done by the SEC back in 2011 and GAO back in
23 2013, and those perspectives are similar to our
24 perspectives and what we see. We've talked about the
25 cost declining, investors' view generally that ICFR is

1 particular, and your focused on getting a drug to market,
2 as I'm sure Bill will talk about, that, you know, having
3 another incremental cost is just certainly something that
4 needs to be carefully considered and we need to
5 collectively be thoughtful, and I know that's what this
6 Committee has been doing for a long time, so I will stop
7 there. I'm certainly happy to answer any questions now.
8 Yes?

9 MR. REARDON: And by way of comparison, it's no
10 longer necessary to be -- that all public large companies
11 are public. If I have a large corporation or business
12 that is owned by a private equity firm but it's as big as
13 many public companies, do those -- and it's an audit
14 client of PwC, in most instances, will that engagement
15 include an audit of internal controls?

16 MR. COMBS: To sign an opinion on internal
17 controls?

18 MR. REARDON: Yes.

19 MR. COMBS: Often not, right? I mean I do
20 believe, as you would expect, that was a portfolio
21 company of a private equity company works up towards a
22 potential IPO, that is when we would typically see more
23 activity in that area and typically, you know, a private
24 equity owner would often request that the auditor step in
25 and start taking a perspective on the effectiveness of

1 the operating controls in preparation for them being
2 public, however, you know, obviously without the data in
3 front of me, we typically do not see people signing
4 opinions on controls when they're private.

5 MR. REARDON: May I ask one other question?

6 MR. COMBS: Sure.

7 MR. REARDON: The exemption from the audit of
8 the internal controls does not exempt the company from
9 the duty to comply.

10 MR. COMBS: That's correct.

11 MR. REARDON: Is there an incremental staffing
12 increase? I mean I go all the way back before Enron, so
13 I remember when we didn't have all of this stuff, but if
14 you were pre-Enron versus now, are you going to have a
15 bigger accounting staff inside your company because of
16 the internal controls requirements?

17 MR. COMBS: Again, I haven't done the analysis,
18 right? But what I -- what I would tell you is, and it's
19 company-by-company specific, right? I do think, from my
20 perception, there is a greater focus on internal controls
21 within a company now versus pre-Sarbanes Oxley.

22 MR. REARDON: No doubt about that, no.

23 MR. COMBS: Right. And I think with that, you
24 know, there's probably incremental cost as well. As
25 people, you know, test the controls in preparation for --

1 because obviously management has an obligation as well to
2 assert to the effectiveness of controls, which it did not
3 before --

4 MR. REARDON: Right, and the exemption, I
5 assume Julie maybe you or Sebastian know, I assume the
6 exemption doesn't extend to the quarterly certification
7 by the CEO and the CFO or principle executive officer and
8 principle accounting officer in SEC speak. They still
9 have to make that quarterly certification, even if
10 they're exempt from the internal control; is that right?

11 MR. GOMEZ ABERO: When we're talking about
12 today, I think it's only the auditors as the stationed
13 part of it.

14 MR. REARDON: Okay. So management's still on
15 the hook.

16 MR. CLAYTON: So Steve and Sara, do you mind if
17 I -- I just -- I think both Mike and I have engagements
18 that we have to get to, but I'm going to try and come
19 back, but I don't want to make a promise in that regard.
20 I just want to say how important this topic is. It's
21 been a long time since Sarbanes Oxley was adopted. It's
22 been actually a long time since our first implementation
23 with 404. I've asked many of the same questions that you
24 just asked. I think a lot of -- a lot of good has come
25 out of the efforts that we've made. We all know that,

1 you know, the bedrock of financial disclosure is GAAP
2 financial statements.

3 I think we all know that to get to those, you
4 have to have a good audit. To get to a good audit, you
5 have to have good controls. But it's -- the devil is in
6 the details and we should be exploring them. So I thank
7 you very much. I don't know, Mike, if you want to say a
8 few things.

9 COMMISSIONER PIWOWAR: I wholeheartedly agree.
10 This is an extremely important topic. The cost and the
11 benefits are -- I mean this is exactly the type of
12 discussion we need to hear right now, so thank you all
13 for coming and thank you for putting this on the agenda.
14

15 MR. VERRET: Just a quick question in reference
16 to the 2013 GAO Study and the 2011 Chief Accountant
17 Study, I read both of them very carefully, and I read the
18 2013 GAO study as actually kind of calling into question
19 the findings of the 2011 Chief Accountant Study in a
20 couple of ways. First of all, GAO took issue with the
21 2011 Chief Accountant Study finding a higher rate of
22 restatement among exempt issuers, where they said, "No,
23 the magnitude is higher," but on a pro rata basis,
24 they're actually the same. And the graphs of how they
25 change over time follow this same pattern.

1 And then the second point that GAO Study made
2 very strongly, at least as I've read it, and you tell me
3 what you think, is that most of the restatements that
4 there were no statistically different pro rata
5 differences in restatements, but to the extent there
6 were, most of those were revision restatements, which the
7 GAO described as not indicating some major problem with
8 financials but were more minor. And I wonder what you
9 think about that. And there's also the -- we should be
10 talking, I think, about the '09 DERA Study for the SEC,
11 which I think is also pretty enlightening on this
12 discussion.

13 MR. COMBS: Yeah, so again, I pointed to two
14 sources of information, right? I think what we typically
15 see with our analysis, and when I do talk about
16 restatements, I've -- you know, typically, we exclude the
17 revisions, right, in that discussion, but what we've seen
18 is a higher level of restatements between exempt and non-
19 exempt companies.

20 MR. VERRET: And isn't it -- isn't it also the
21 case that a majority of the time, findings of material
22 weakness in internal controls under 404(B) failed to
23 predict restatements? In other words, most restatements
24 are not preceded by finding of material weakness?

25 MR. COMBS: I think in a lot of -- you're

1 absolutely right. I mean and I do think that gets back
2 to, you know, people being challenged in general, both
3 management and auditors, around our material weakness, is
4 it being called soon enough, right? So I do believe
5 there's an element of that that still needs to be
6 considered and addressed.

7 MR. YADLEY: Thank you very much. We
8 appreciate you being here and sharing your knowledge.
9 And as the Chairman said, the devil -- the devil is in
10 the details and one of the ways you can see this happen
11 is when a smaller public company changes auditors. They
12 can be moving along, no problems, clean opinions, no
13 issues, change auditors and, all of the sudden, there's
14 all kinds of exceptions. And it's not that the old
15 auditors weren't good and the new auditors are better,
16 it's that this framework imposes a lot. And a fresh look
17 is always good; it can certainly lead to improvements,
18 but in many cases, it's a matter of you have the
19 infrastructure and this sort of behemoth overall
20 framework that causes you to rethink everything.

21 It's almost like when you change insurance
22 companies and you're on a drug that really helps you and
23 you've been through everything else and now the new
24 insurance company says, "Well, we're not going to pay
25 for this expensive drug. We want you to try all of these

1 audit, right? So just to react to that.

2 I think in regards to, you know, documentation,
3 there's certainly guidance that has been provided by the
4 SEC in regards to what's expected. I think the SEC's
5 view is not dissimilar to what the PCAOB's view is in
6 regards to, you know, what's required under, you know,
7 the assertion and the attestation regarding internal
8 controls.

9 I will tell you there's a practical challenge
10 from an audit standpoint in regards to understanding
11 controls that are not documented. I don't think -- I
12 think that the COSO framework and the work that COSO did
13 on small business -- small entities really tried to get
14 after that and say that in smaller businesses, you may
15 not have the formality that you would have in a larger
16 business for a number of reasons, right? They're smaller
17 management teams, sometimes less sophisticated internal
18 control structure that are more focused on, you know, a
19 handful of people executing those controls on a day-to-
20 day basis.

21 So I do certainly think that that's recognized
22 in the guidance, but there is a practical challenge to
23 that when an auditor who's not involved in the execution
24 of the controls comes in and has to try to understand
25 what may have happened, you know, two, four, six months

1 other things." So I think that is a problem. I think
2 the profession cares about its clients and understands
3 that clients don't want to pay more than they need to
4 pay. But this is an area where almost by its nature,
5 it's expensive. And part of it is also the
6 documentation, particularly smaller companies, as Patrick
7 or you inquired, yeah, there's more staff just to keep up
8 with the documentation that I think I some cases has
9 benefit and some cases not. So I guess I'd like your
10 views as to whether you see -- because I see out in the
11 field that there's still a one size fits all mentality in
12 this area.

13 MR. COMBS: Well, there's a lot there, right?
14 I mean -- and I'll start with your first comment, and I
15 don't think it's related to 404(B). And I don't think
16 it's actually related to auditing or anything to do with
17 the profession. When a new set of eyes looks at
18 something with a different -- with different experiences,
19 different training, et cetera, I think all of us
20 collectively, you know, will bring a different
21 perspective, so I think that's when you change -- your
22 comment on changing auditors and having a different
23 perspective raises, you know, things that we see as well.
24 I'm not sure that that's solely related to 404(B). I
25 mean I think we see that in a financial statement only

1 earlier and without that level of documentation, there's
2 a practical challenge to that. So I do think that that's
3 something that people try to look at and try to focus on
4 and be as flexible as you can in the context of gathering
5 corroborative evidence, but there's always a practical
6 challenge to that and I think that's a fair point.

7 CO-CHAIR HANKS: Len, could I ask do you have
8 any actual numbers, any data on the bills that are being
9 presented to the companies? I was really interested by
10 the comment that you made that sometimes when you bring
11 on the 404(B) attestation, the pure audit cost goes down,
12 which is kind of intriguing, but is there any source out
13 there for the dollar number invoices that are being
14 delivered to companies?

15 MR. COMBS: Well, I mean all of our audit fees
16 are publicly available for public companies, if that's
17 what you mean. So --

18 CO-CHAIR HANKS: Are they -- are they broken
19 down? Is there an easy way of extracting that?

20 MR. COMBS: I think the question -- let me ask
21 a question and then I'll respond. Are you asking is
22 there a breakdown between the cost of the financial
23 statement audit and the 404(B) audit?

24 CO-CHAIR HANKS: Yes.

25 MR. COMBS: There's not, right? As I said, one

1 of the important things we try to do is integrate the
2 audit so where one starts and one begins -- where one
3 ends and one begins is often difficult to ascertain. The
4 better -- the better you do integrate the audit and
5 given, as I said, many of the procedures you do under one
6 are similar to the other, we typically would not break
7 that down.

8 I will tell you one can sometimes look at that
9 as when someone is not required -- when someone's exempt
10 and then they go into, you know -- then they have to have
11 a 404(B) audit. There's probably some information with
12 that. I will tell you what's probably a little bit
13 misleading about that, though, is as with most things, I
14 think in the first year, there's often what I'll call a
15 startup cost.

16 CO-CHAIR HANKS: Yeah.

17 MR. COMBS: Whether it's, you know, really
18 working with management to understand what are those most
19 important -- what are the most important controls and
20 trying to determine that, assessing with management
21 whether those controls are truly operating as they're
22 designed. Once you get into that, often in cases, there
23 will, particularly in the first and second year of a
24 404(B) audit be what I'll call remediation that
25 management has to undertake to get their controls, you

1 know, at the right spot. So there are certainly startup
2 costs that I would say are not recurring.

3 When we think about it, an integrated audit and
4 the incremental costs, we typically think it's about 15
5 to 20 percent, approximately. Now, that being said, as I
6 mentioned previously, the smaller the company, I think
7 the more important that could be because I do believe,
8 you know, there are elements of internal control that
9 when you think about it, whether it's, you know, for
10 example, the competency of the management team or the
11 assessment of an IT system, that you frankly just can't
12 spread a -- you don't get the economies of scale with a
13 smaller company that you would with a larger company.

14 So I do think we think about that in the
15 context of our portfolio as a whole versus, you know,
16 there's probably a range of that, depending on the size
17 of the company.

18 CO-CHAIR HANKS: All right. That was useful.
19 So if anyone wanted to do to a study on this, the place
20 to focus would be companies who have recently lost their
21 exemption and how that changed both in the first couple
22 of years and then maybe --

23 MR. COMBS: I think you'd have to look at it
24 over a period of time and, again, I think -- I think
25 there would have to be an analysis of smaller versus

1 larger companies because I do think there'll be a
2 continuum of that.

3 CO-CHAIR HANKS: Thanks.

4 MR. VERRET: Just -- I just want to reference
5 one point. There's a wealth of data, some of it funded
6 by the PCAOB, to Chairman Doty) credit, he's been willing
7 to fund stuff that's even critical of SOX and the PCAOB.

8 One of the studies they fund is by Dorma Palla, looks at
9 firms just above and below the threshold of \$75 million
10 and finds that firms manage their public flow just to
11 avoid going past that threshold. They're willing to give
12 up raising an average of \$2 million in equity just to get
13 below the threshold through, you know, buybacks or
14 whatever. And he associates that with an expected at
15 least one time cost from the transition of \$4 to \$6
16 million in compliance costs that they're trying to avoid,
17 based on what they're willing to pay to avoid it.

18 So that's one attempt to kind of look just
19 above and below the threshold.

20 CO-CHAIR HANKS: Maybe you could send a link to
21 that around to the -- thank you. Anything else for Len?

22 MR. HINMAN: Len, do you -- sorry. Was there
23 another question? It'd be interesting to know whether
24 you have any observations around the evolution of sort of
25 enterprise software and accounting software in this area.

1 I know there are a lot of products that have been
2 introduced that make it a lot easier and cheaper for
3 companies to not have to do so many manual adjustments
4 where restatements are rife and to be more systems-based.

5 Is that an area where we're optimistic that
6 cost may come down and/or compliance may go up?

7 MR. COMBS: You know, I do think that certainly
8 what we've seen over the -- not just the last 10 or 15
9 years, but over 20, 25 years, right? That companies' use
10 of technology has certainly grown and improved and to the
11 extent that they're employing technology in a smart way,
12 you know, the manual intervention override certainly
13 diminishes. I mean I was having, you know, as an
14 anecdote, I was having this conversation the other day
15 about, you know, bank reconciliations, right?

16 And, you know, if you go back 20 years, there
17 was often a lot of manual bank reconciliations that would
18 have to happen because of the timing of certain things
19 and now with, you know, the online environment that
20 companies have and the treasury systems they have and the
21 interaction with the bank on almost a real-time basis,
22 you know, bank reconciliations don't take a long time
23 now, right?

24 MR. HINMAN: But -- and do we see companies

1 sort of being driven to adopt more sophisticated systems
 2 as they prepare for a 404 audit or is that something
 3 you're recommending? Is that one of the incremental
 4 costs that we see that may have longer term benefits, but
 5 there's some front-ending to that?
 6 MR. COMBS: Yeah, I do think that there is some
 7 front-ending of cost and I do think not just for 404(B)
 8 but in an effort, frankly, to become more efficient
 9 themselves to the extent that a company can implement,
 10 you know, automated repeatable controls versus manual
 11 controls that require a lot of human intervention. I
 12 think they're both more effective and efficient. Some
 13 companies choose to take that path and really try to
 14 drive the automation and standardization with the
 15 company. Others, for many reasons, including, you know,
 16 antiquated systems, et cetera, may not think there's a
 17 cost benefit analysis there, but we still certainly see,
 18 you know, as companies move towards 404(B) and they
 19 really start thinking about, you know, controls and the
 20 efficient operation of controls, there is a drive for
 21 more automation and standardization in what they do.
 22 MS. YAMANAKA: So I have a clarification point
 23 on that. So when you were speaking and, by the way, I'm
 24 ex-PwC, so my thoughts are always with you guys and I
 25 totally get that side of it.

1 MR. COMBS: Right.
 2 MS. YAMANAKA: But now I'm on the other side of
 3 operations. And so if we're looking at the total number
 4 of accounting structure, financial accounting structure
 5 support resources that are in an organization and we're
 6 saying now, the last 20 years, 10 years particularly, ERP
 7 is driven all the way down to the smallest companies, and
 8 by definition, nobody should be doing the manual bank rec
 9 anymore, so you have less people doing those manual jobs,
 10 but the incremental cost is probably higher in the
 11 control area, right?
 12 So if we were looking at things in total
 13 incremental cost doesn't look that high from a maybe
 14 external cost or in internal resources, but in reality,
 15 if we look at who's doing what now, less people doing
 16 bank recs transaction work, more high-powered work in
 17 terms of controls, analysis, et cetera, but the real cost
 18 for that is probably buried within the internal operation
 19 of the company and we can't look at it on an incremental
 20 basis. Do you think that's a fair analysis or --
 21 MR. COMBS: Obviously, a very complex question
 22 because you're talking about an evolution of technology
 23 and controls over, you know, many, many years and to make
 24 a blanket statement about, you know, companies at large
 25 would be very, very difficult. I do think what we've

1 seen is over many years, not just as a result of 404(B),
 2 but you know, companies have automated what they do,
 3 third parties that they interact with have automated what
 4 they've done and accordingly, in everything we've seen,
 5 technology has certainly driven down the cost of doing
 6 things, right, and made things more efficient and more
 7 effective. That being said, I do think there's a cost of
 8 404(B) that's internal as obviously as well as external.
 9 And a lot of it, the internal costs are around
 10 management checking that the controls are working
 11 effectively.
 12 Now, to the extent that those are automated
 13 controls, it's much easier to check and validate than it
 14 is a manual control. But, you know, I do think that
 15 there's an element of compliance cost that is incurred
 16 internally by the need to assert to the effectiveness of
 17 controls.
 18 MS. YAMANAKA: Thank you. And just to
 19 collaborate with what you were saying regarding those
 20 costs, I think that from my experience, I see, you know,
 21 when people are looking at getting audited for whatever
 22 reason, that anticipation of audit changes behaviors,
 23 right, at whatever level you are.
 24 MR. COMBS: Which could be a good or a bad
 25 thing, right? It's both.

1 MS. YAMANAKA: And -- well, in my opinion,
 2 usually it's a good thing.
 3 MR. COMBS: Right.
 4 MS. YAMANAKA: It makes my job easier
 5 definitely. But I think that's one thing that we have
 6 not explored here is what is the kind of like threat
 7 implication of changing people's behaviors in their
 8 getting ready for whatever activity they have or
 9 preventing their activity from moving forward, so thank
 10 you.
 11 CO-CHAIR HANKS: Thank you. We will move on to
 12 Bill.
 13 MR. NEWELL: Thank you very much. I have some
 14 slides that'll be up here in a second, but let me say
 15 first of all, it's my privilege to be here. As a former
 16 corporate securities lawyer who advised clients on
 17 auditing -- related to auditing financial statements and
 18 other matters, it's an area that I have a fair amount of
 19 familiarity. And also, as a leader in a number of
 20 smaller public biotech companies, you know, I think back
 21 to a lot of changes that we had to address as a
 22 management team in the way we presented our financial
 23 information.
 24 And now as a leader of a small privately held
 25 biotech company trying to make a difference in cancer

1 looking forward, I hope, to a public offering next year,
 2 thinking about the changes that we're going to go through
 3 as a public company and then thinking about the changes
 4 as a small reporting company that we're going to
 5 anticipate, I always like to look ahead and understand
 6 what's going to be required of us so that we can be
 7 prepared to meet our obligations. So 404(B), I think has
 8 been in the main helpful, but for the smaller companies,
 9 and that's the group that I want to address with you
 10 today, and particularly those in my industry, the biotech
 11 industry, we think it's overly burdensome and we would
 12 appreciate some additional flexibility beyond what exists
 13 in the statute today.

14 I am going to recommend that companies be
 15 exempted where their public float is less than \$250
 16 million and also, I would recommend that if you have
 17 annual revenues that are less than \$100 million, you also
 18 have an exemption that continues as well. And the \$100
 19 million revenue number is, I think, it may be a new one
 20 for your consideration, but it's one that we think is
 21 appropriate given the cost and the burden of going
 22 through the 404(B) attestation and examination.

23 Len outlined that companies have to have an
 24 external audit of their internal controls. What I want
 25 to emphasize, however, is that companies, whether they

1 had an audit or not, still have an obligation to have
 2 internal controls and management is required to attest to
 3 their effectiveness. So what we're talking about today
 4 are the benefits of an audit. It's not that companies
 5 don't do it, and it's not that we don't take them
 6 seriously and attest to them, it's a question of what is
 7 the cost benefit of the audit. And for the smaller
 8 public companies, I would tell you that I think the cost
 9 benefit is not where it should be.

10 So let's start with a look at which companies
 11 have to have a 404(B) audit. And there are two
 12 categories of companies. If you are a non-accelerated
 13 filer, you have a public float below \$75 million and you
 14 have an exemption from 404(B) as long as you remain in
 15 that category. As an aside, according to the Securities
 16 and Exchange Commission, these companies currently make
 17 up just .01 percent of the total public float on the
 18 market. So we're talking about a really small share of
 19 investor value that falls within the category of a non-
 20 accelerated filer.

21 As Len alluded to, emerging growth companies,
 22 which is a term that was created in the Jobs Act, have a
 23 five-year on-ramp to 404(B), and this is the standard of
 24 what an emerging growth company is. At the end of that
 25 five-year period, they go back into a normal

1 categorization, and that means that if you are above \$75
 2 million, you now have to have an audit of your internal
 3 controls.

4 The Advisory Committee endorsed increasing the
 5 public float limit for non-accelerated filers to \$250
 6 million in 2015, and I believe the SEC should enact that
 7 reform. This April marked the 5th anniversary of the
 8 Jobs Act, so we're starting to see companies roll off
 9 their 404 (B) exemption and these companies are still
 10 many years away from product revenue.

11 As a consequence, and as I will document for
 12 you, a number of companies will be diverting funds from
 13 scientific research and clinical development to
 14 compliance costs to anticipate the 404 (B) audit; 229
 15 companies have gone public -- biotech companies have gone
 16 public under the Jobs Act. Virtually all of these
 17 companies have a public float above \$75 million, despite
 18 the fact that the average company has fewer than 100
 19 employees and no product revenue.

20 The companies are given credit in the
 21 marketplace by virtue of the fact that they are making
 22 important new medicines that investors believe will have
 23 a financial return for them. But they do not yet have a
 24 financial return available to them. And it will be many
 25 years before many of these companies ever see product

1 revenue. You can see on the slide that I've put up the
 2 impact that the five-year period will have in the coming
 3 years. We now have eight companies that went public in
 4 2012 that are rolling off their exemption this year, and
 5 there are going to be dramatic increases in 2013 and in -
 6 - for 2013 and 2014 publicly floated companies.

7 The 80 biotech IPOs in 2014 represent the
 8 single largest year for IPOs and in 2019, just a little
 9 over a year-and-a-half from now, they will all face the
 10 cost burden of 404(B) compliance, so this is a very
 11 timely conversation for us to be having. The impact on
 12 the biotech companies that I am speaking about is
 13 significant. We see increases in cost attributable to
 14 404(B) that can be anywhere from \$300,000 to \$600,000
 15 when you combine the incremental audit fees, external
 16 consultants and internal costs. So that gives you a
 17 range based on the companies that we've talked to. And I
 18 will give you some specifics here in a minute.

19 To put this in perspective, a typical biotech
 20 company would spend that amount of money on three to six
 21 research scientists for a year, who are working to
 22 deliver new medicines, whether it is for cancer,
 23 Alzheimer's or other indications that we as an industry
 24 are pursuing. The absence of having those three to six
 25 researchers delays our research and impacts adversely our

1 ability to discover and develop new medicines.
 2 The costs, by the way, we don't believe are
 3 decreasing, in the main, they seem to be increasing as
 4 the PCAOB has increased pressure on audit firms.
 5 Anecdotally, I will tell you that while I think it's fair
 6 that people do try to scale the audit reviews of
 7 controls, in fairness, the PCAOB wants to have high
 8 standards for all auditors and as a consequence, I think
 9 many of the small companies feel like they're being
 10 treated as if they were Pfizer.
 11 I reached out to several colleagues in our
 12 industry and they all told me a similar story about the
 13 cost burden of 404(B) and the value -- lack of value it
 14 creates for investors. So I'm going to talk about a
 15 couple of companies here on the next slide. In Example A
 16 that I have put up, this company went public before the
 17 Jobs Act and did not benefit from the five-year Jobs Act
 18 exemption. They estimate that their costs for 404(B)
 19 audit are north of \$400,000. And it's worth remembering
 20 that this is an annual incremental cost to the company.
 21 The company has a public float of around \$2 million, but
 22 they are still prerevenue and have just 60 employees.
 23 Some detail, their costs included \$250,000 paid to their
 24 auditor just for the 404(B) audit. Their full audit fee
 25 was \$450,000, so that gives you an example of what the

1 burn. Those are the two things that biotech companies
 2 want investors to pay attention to because those are the
 3 most relevant to the company's ability to actually earn
 4 investors value from an increase in the stock. Because
 5 without cash, we are not making new medicines. And
 6 without the promise of new medicines, the company's value
 7 will not rise.
 8 We've talked to many of the companies in
 9 preparation of this hearing, and uniformly, no one has
 10 ever had an investor conversation about 404(B) and
 11 whether their controls are properly in place as a result
 12 of an audit. It's just not something that investors care
 13 about for biotech companies because it's not relevant to
 14 their investment decision.
 15 You know, we've now had almost five years --
 16 have had five years of exemptions for these no-
 17 accelerated filers and I'm not certain that we see any
 18 harm for the people who have been in the emerging growth
 19 company sector to their financial statements as a result
 20 of not being compliant under 404(B). I just don't think
 21 we have the luxury to do the sort of financial
 22 engineering that an Enron or a WorldCom was able to do.
 23 We put our money to work for science and we don't have
 24 time to play games with it. And, as I said, in the main,
 25 we can't manipulate our cash balances. Those are what

1 cost differential is; \$150,000 for internal labor and
 2 another \$40,000 for additional consultants.
 3 Example B is another company that went public
 4 before the Jobs Act as well. Their public float, \$560
 5 million, would've qualified them as an emerging growth
 6 company had they gone public under the Jobs Act; \$240,000
 7 of their audit fee was attributable to 404(B), plus an
 8 additional \$105,000 in internal costs and \$30,000 to
 9 outside vendors, all of which aggregates to \$375,000 per
 10 year. This company has 80 employees; half of them are
 11 PhDs. And the spend of nearly \$400,000 on the audit is
 12 just not a good use of their capital.
 13 The reason that this is such a damaging
 14 diversion of capital is because all of this does not
 15 provide any meaningful protection or useful information
 16 to investors. As I said, companies are still required to
 17 maintain and attest to internal controls, regardless of
 18 whether they are 404(B) compliant and investors really do
 19 not gain, I believe, any meaningful information from the
 20 incremental cost.
 21 Biotech investors, in particular, look to a
 22 company's science. They look to the product
 23 opportunities that the company is developing. They look
 24 to the clinical pathway that the company is pursuing, and
 25 they keep an eye mostly on the company's cash and cash

1 they are, and our burn rates are what they are. Those
 2 are the things that investors care about.
 3 So let me add a couple more real world examples
 4 that are about to occur to companies that are going to be
 5 losing their exemption. So Example C, Company C here did
 6 their IPO in 2012. They will lose their exemption this
 7 year. And they are learning firsthand the difficulty of
 8 404 (B) compliance. The CFO I spoke with described a
 9 conversation with his auditor where they projected a 100
 10 percent increase in his audit fees due to 1,000
 11 additional man hours necessary to complete the 404 (B)
 12 audit. That increase will cost the company \$250,000.
 13 Other additional costs include an increased fee to their
 14 consulting firm of \$60,000, a new part-time consultant
 15 specifically to manage the day-to-day of the audit at
 16 \$50,000, plus other internal costs not yet quantified.
 17 For context, this company has 60 employees and
 18 it has a public float of \$85 million. And this single
 19 compliance exercise will increase their annual burn rate
 20 by 1 percent, just to do that. Example D is a 2014 IPO
 21 company that still has a couple of years left on its
 22 404(B) exemption, but they've already started to prepare
 23 for compliance. Their \$240 million public float will put
 24 them outside the non-accelerated filer definition as it
 25 currently stands and they, as well as the Company C, are

1 exactly the sort of sub \$250 million company that would
2 benefit from the changes that I'm proposing.

3 Already, as they think about the costs of
4 compliance, they estimate a significant increase in their
5 audit fee of about \$325,000 and a total increase cost of
6 about \$500,000. Other Jobs Act companies that we spoke
7 to anticipate their exemptions expiring in the next few
8 years and they believe they will incur somewhere between
9 \$150,000 to \$350,000 in additional audit fees, \$50,000 to
10 \$150,000 in other consulting costs and either \$40,000 or
11 as much as \$200,000 for internal labor. In some cases,
12 these companies are planning to hire an FTE for the
13 finance team instead of hiring a scientist, which is a
14 real shame.

15 I have heard, and Len alluded to, that 404(B)
16 audit can improve the debt financing rates that we might
17 get. Well, I will tell you that we just raised \$15
18 million in debt financing and we would have to lower our
19 interest rate that we pay on that debt financing by 1
20 percent to pay \$400,000 of audit costs, were we to get
21 there, and that would just be for one year. I don't
22 think we will ever get a cheaper debt financing vehicle
23 if we were compliant with 404(B).

24 Fortunately, the SEC is considering reforming
25 the public float threshold of \$75 million. Last summer,

1 the SEC followed the Advisory Committee's recommendation
2 to amend the smaller reporting company definition by
3 increasing that public float from \$75 million to \$250
4 million. However, the SEC did not propose a
5 corresponding reform to the non-accelerated filer
6 definition, which the Advisory Committee had recommended.

7
8 An increased small reporting company definition
9 would allow growing companies certain scale disclosure
10 requirements on their quarterly and annual filings, but
11 the big ticket cost driver of 404(B) is governed by the
12 non-accelerated filer definition, not the small reporting
13 company definition. Fortunately, the SEC did solicit
14 comment and that's one of the reasons that we're here
15 today. Numerous organizations filed comment letters
16 endorsing a change in the non-accelerated filer
17 definition and its associated 404(B) exemption.

18 The comment letters echoed a proposal put forth
19 by the SEC's Small Business Forum for the last eight
20 years to amend both the small reporting company and the
21 non-accelerated filer definition to include companies
22 with a public float below \$250 million or revenue below
23 \$100 million. Supporters included innovation industries
24 like the biopharmaceutical and medical device industries,
25 economic drivers like community bankers, advanced

1 manufacturers, the venture capital industry and both of
2 the major national securities exchanges.

3 The public float test of \$250 million would
4 harmonize the small reporting company definition with the
5 non-accelerated filer definition as well. They're
6 already thought of interchangeably by many market
7 participants and we believe that the same standards
8 should apply to both tests. The revenue test that I
9 speak of, \$100 million, would be a new addition to both
10 of those definitions, and I think it's an important one.

11 Public float ultimately recommends investors predictions
12 about the future of the company, but it doesn't reveal
13 much about the company's present ability to pay for
14 expensive compliance burdens like 404(B).

15 The current non-accelerated filer definition
16 allows a company to use a revenue test if it cannot
17 calculate its public float. That test is set at \$50
18 million in revenue, but commenters on the SEC's proposal
19 supported a stand-alone revenue test irrespective of
20 public float. The small business -- the SEC Small
21 Business Forum made the same proposal. Companies would
22 be able to qualify as a non-accelerated filer and a small
23 reporting company if their revenues are less than \$100
24 million annually.

25 Ultimately, I would argue that revenue is a

1 more appropriate arbiter of a -- than company size -- an
2 important arbiter of company's ability to pay than public
3 float. So I'm hopeful that the SEC will consider a
4 revenue test in addition to the public threshold test.

5 Two final points that are worthy of
6 consideration. The first is we are not talking about a
7 large universe of companies with a tremendously big
8 market cap. The SEC calculated last summer that
9 increasing the public float test to \$250 million would
10 allow companies representing .02 percent of total public
11 float on the market to qualify for that exemption.

12 Obviously, this is a small investor risk in
13 terms of the overall market. Second, and more
14 importantly, lack of investor and issuer desire for this
15 requirement does exist. Now, if the fact of the matter
16 is that these sorts of audits would drive investors to
17 our companies, reduce our costs of capital, companies
18 would be not taking advantage of the exemption, they
19 would be having the audits done, and that speaks volumes
20 that they're not doing that. So by making compliance
21 optional for a broader range of growing companies, you
22 preserve valuable funds for innovation and preserve the
23 option for the companies and their investors to opt in if
24 they feel that it's necessary. I think the fact that
25 they're not opting in tells you that they don't feel that

1 it's necessary.
 2 I hope you all will follow on your proposal
 3 from last summer and bring the non-accelerated filer
 4 definition into line with the proposed small reporting
 5 company definition. Thank you very much for your time.
 6 CO-CHAIR HANKS: Questions? Patrick first.
 7 MR. REARDON: Yeah, I'm the obsessive
 8 compulsive one who's always got a question. Is it Dr.
 9 Newell or Mr. Newell?
 10 MR. NEWELL: No, you can call me mister. Thank
 11 you.
 12 MR. REARDON: Why bother going public?
 13 MR. NEWELL: (Laughter) It's a really good
 14 question. When you think about the cost of the
 15 developing a new medicine and you think about the capital
 16 that's available to you as a private company, you can
 17 stretch that capital to a certain point in time, but then
 18 you get a point, get to a point where you need the
 19 greater resources that are available from a public market
 20 environment. Our company, which was founded in 2003 and
 21 has been fortunate, we've raised \$100 million in venture
 22 capital. We've raised another \$200 million in non-
 23 dilutive revenue through partnerships. So that's \$300
 24 million. And we're just about now, at the end of this
 25 year, to file our first investigational new drug

1 application with the FDA to put our first drug in the
 2 clinic.
 3 We'll put two more in the clinic beyond that in
 4 the next 12 months. And that's an incredible cost.
 5 That's going to cost us \$60 to \$100 million over the next
 6 two years for clinical development costs. The private
 7 venture capital markets will not support that and so we
 8 will consider, if the markets look favorably on us, going
 9 public because it gives us access to a larger pool of
 10 capital and we know that there are costs associated with
 11 that access. And we don't mind the cost as long as the
 12 costs are relatively important for investor protection.
 13 Where they're not important for investor protection, we
 14 view those costs as a waste of money.
 15 MR. REARDON: This might not be a fair
 16 question, but -- and it may not be one you should answer,
 17 but what do you estimate your cost of preparing a
 18 registration statement and getting it to be effective as
 19 far as SEC compliance goes, I mean just the whole thing,
 20 not just the audit.
 21 MR. NEWELL: Understood.
 22 MR. REARDON: And your annual compliance costs,
 23 what do you estimate those to be? Are you budgeting?
 24 MR. NEWELL: Yeah, the first one is easier for
 25 me to answer because we've already done that analysis.

1 It's going to be about \$3 million.
 2 MR. REARDON: \$3 million and you're not making
 3 any money.
 4 MR. NEWELL: Yeah. No. No, sir. The other, I
 5 will be talking to my CFO in the next month about as to
 6 what our ongoing costs are going to be as we do our 2018
 7 budget.
 8 MR. REARDON: Would you say I was out of the
 9 ball park if I just took a wag and said \$1 to \$2 million?
 10 MR. NEWELL: I wouldn't dispute that.
 11 MR. REARDON: Thank you.
 12 MR. VERRET: Not to sound like the resident
 13 academic, but I wanted to throw out for the record and
 14 for the Committee's consideration, and also to the extent
 15 DERA is going to need to buttress corp fin's work on
 16 this. A couple points of evidence consistent with what
 17 you've been talking about here in critiques of 404(B), so
 18 Professor Lobo in Journal of Accounting Auditing Research
 19 finds that when you control for the benefits -- and
 20 Patrick's alluded to this, when you control for the
 21 benefits of 302 and 44A, it's hard to find any benefit in
 22 404(B). And a lot of the studies that find a benefit
 23 here lump them all together, and that's a huge mistake.
 24 So controlling for that, 302, 44A, pretty good
 25 at limiting stock price volatility, 404(B) is not. One

1 of the leading critiques to be the most important thing
 2 for us to think about, Rice & Webber, Journal of
 3 Accounting Research 2012 finds that a majority of the
 4 time for findings of material weakness under 44B, do not
 5 proceed material restatements in the financial
 6 statements. So in one year that they studied, 84 percent
 7 of misstatements -- of restatements were not proceeded by
 8 a finding of internal control weakness during the period
 9 of the restatement.
 10 The 404(B) audits failed 84 percent of the time
 11 that year. I mean there's just -- to me, that's very
 12 powerful evidence of reconsideration of the cost of
 13 404(B), not just in the small firm context but across the
 14 board. And, you know, I would suggest that even beyond
 15 our jurisdiction, a reconsideration of the cost of
 16 404(B). So just wanted to through that out there for
 17 your consideration.
 18 MR. NEWELL: Thank you very much. That doesn't
 19 surprise me a tall. And, as a matter of fact, when a
 20 small public company like a biotech has a restatement, I
 21 don't know that investors really care that much about it,
 22 as long as their cash balance is still what it was the
 23 day before the restatement. We don't look to financial
 24 metrics for public biotech companies. Industries don't
 25 look to financial metrics to public biotech companies the

1 same way they look to metrics for revenue producing
2 companies. What investors are looking at is what is the
3 future potential of the drugs that you're working on to
4 develop and how does that translate into a return on
5 their investment? That's what they care about. And they
6 care about how much capital you have available to
7 actually deliver on the promise of your new therapies.

8 CO-CHAIR HANKS: Greg, go ahead.

9 MR. YADLEY: I was going to say I sat next to
10 J.W. and wore the same suit so that I can piggyback on
11 his data.

12 MR. VERRET: Really good, different tie.

13 MR. YADLEY: Thank you very much, Bill. This
14 is back to you Len because I think you've both reminded
15 everyone that an audit of the financial statements
16 doesn't include, by its very nature, some review of
17 internal controls, and also under 404A, that management
18 is making an assertion under penalty of perjury of
19 certification as to internal controls. How do you
20 believe the profession is doing in terms of giving credit
21 for two things in the internal control area? First, the
22 tone at the top, which is extremely important from a
23 governance perspective and particularly in smaller
24 companies with fewer employees, it really matters who the
25 CEO is and how involved the board is and what the tone of

1 So it's a similar concept that they don't have the
2 ability or would rather spend their money in a different
3 way versus hiring internal audits. So often, that's the
4 case. I mean is that --

5 MR. YADLEY: Yeah, no, there -- I don't know of
6 any small biotech company that's public that has an
7 internal audit function. It just doesn't exist.

8 MR. NEWELL: Yeah, that would -- that would be
9 for operating companies.

10 MR. COMBS: Yeah, in regards to your -- to your
11 first question, tone at the top, I mean as you say, it's
12 hugely important, tone at the top, particularly when you
13 think about, you know, fraud considerations and how you
14 think about that. I do think, at some level, given
15 auditors have the ability to assess risk and determining
16 the nature/timing/extent of their work, to the extent
17 that they believe there's not good tone at the top or
18 that's been questioned in the past, I do think that
19 drives, you know, incremental work, meaning you may need
20 to test a control, but if you're not comfortable with the
21 tone that management's setting, which includes hiring
22 competent people and other things, I certainly think that
23 would drive, you know, the level of work you need to --
24 the number of times when you do the testing of those
25 controls. But it's certainly less directed. I mean tone

1 the top is.

2 And then the other area is internal audit,
3 where a company has a person or a function separate from
4 operations that is looking at this area. How do they get
5 credit with respect to internal controls reviews for
6 small companies?

7 MR. COMBS: So the second one is a lot easier.

8 What I would say, and Bill can probably share his
9 experiences as well, is many of the types of companies
10 that Bill is talking about would not have internal audit
11 functions, so often it's difficult for us to kind of
12 leverage that work. To the extent that a company does
13 have an internal audit department, we are very much able
14 to and do significantly leverage the work that internal
15 audit does over their assessment of internal controls.
16 And that's one of the changes that when I talked about
17 changes in 2007, that was one of the important changes
18 that allowed us to even increase the level of reliance on
19 internal audit. And so I do think that there is a huge
20 opportunity to do that. And I do think broadly speaking,
21 you know, auditors do that. I think often, however, the
22 size of companies we're talking about and Bill's talking
23 about, you know, not dissimilar to having an external
24 consultant, often the external consultants they're
25 talking about are serving a quasi-role of internal audit.

1 at the top is not a direct control.

2 MR. HAHN: I'd just like to add to some of your
3 comments here. We represent -- we're actually one of
4 those 80 biotech companies that went public in 2014 that
5 about a year-and-a-half, two years from now, we will be
6 404(b) compliant. We will still be prerevenue. Again, I
7 won't go through all of the details because I can support
8 all of those numbers, but we're looking at about \$500,000
9 of increased costs. I think it's important to kind of
10 drill down a little bit and give a little bit more
11 detail, though, that 99 percent of our assets on our
12 balance sheet are still cash.

13 We have 42 employees. We cut 125 checks a
14 month. And the CEO and are are still the only two check
15 signers. So, you know, since we've been public, we've
16 had say 500 investor meetings, same thing. What's your
17 cash balance? How far will it get you? Where is the
18 data? I do also want to add, though, that I think the
19 revenue test is important because right now, we're over
20 the \$250 public float. Our current market cap is close
21 to \$400 million. So the revenue test would be important
22 for companies. I know there's several hundred companies
23 that are in the same boat as we are. But I'd also like
24 to add though that, you know, we are, you know, 404(a),
25 so the CEO and I have to sign our name on the line, and

1 we do spend right now about \$25,000 outside for a third
2 party that reports directly to our audit Committee.

3 So there is some comfort from the audit
4 Committee towards our internal controls, so I do think
5 there is a scalable solution here to get away from the
6 one size fits all.

7 CHAIRWOMAN BANKS: On the subject of one size
8 fits all, is there any reason -- I know you talked about
9 the \$100 million revenue test. Any reason why that
10 wouldn't be equally applicable to non-bio companies? Is
11 there any distinction between non-bio companies and
12 others who are pre-revenue?

13 MR. NEWELL: Yeah, I think that --
14 -- a good question. I'm not advocating for it
15 only for biotech companies. I think the lion's share of
16 public companies, though, that are going to be above \$250
17 million are most likely going to be biotech companies.
18 That's just the nature.

19 We have investors who are investing in the
20 promise of our therapies. Most investors invest in the
21 product that's on the market and the sales trajectory and
22 -- and that sort of thing. So I don't know that there's
23 any particular logic that says a non-biotech company that
24 meets the threshold shouldn't get the same -- shouldn't
25 get the same treatment. It all comes down to what --

1 what's a reasonable financial burden for a company to
2 undertake and what's the investor benefit for that
3 financial burden.

4 And, you know, when you're under \$100 million
5 in revenue, you're -- particularly as a biotech company,
6 and Brian knows this well -- you look at every expense
7 and have to justify it to yourself because what we're
8 trying to do is something that's pretty darn difficult.
9 That is, understand human biology and intervene in it in
10 a way that can be life-saving. So we look very carefully
11 at expenditures to justify them.

12 MR. COMBS: If I could just add to that. I
13 mean, hopefully, you know, I tried to present a balanced
14 view, but I do think that -- that when you look at this,
15 and to what Bill said and what Brian said, I think you
16 need to look at the risk related to the company, and the
17 risk that exists at a, you know, pre-commercial company
18 are different and usually not very -- not nearly as
19 complex as they are at a commercial company. Right?

20 And so, you know, the benefit, in fact, you
21 know, may be less at a pre-commercial company and how you
22 spend your money is important, and if -- if -- you know,
23 I think Bill is fair, because I come from this industry
24 as well. Investors are looking at what the -- what the
25 future value of the pipeline is and the products and the

1 fact that they are looking at cash burn. That presents a
2 much different risk profile for a company than a -- than,
3 you know, like a biotech company that has launched
4 commercial product and is dealing with the challenges of
5 revenue recognition and the complex payer system that
6 exists in the U.S., as et cetera.

7 So I do think it's important, and I certainly -
8 - I 100 percent say that it really needs to think about
9 the risk that's presented by a company.

10 CO-CHAIR HANKS: Anybody else?

11 MR. REARDON: I have one. It's not a question
12 but an observation. We've had presentations in the past
13 on the declining number of public companies, and to state
14 the obvious, I think this is -- this kind of cost -- and
15 this is not the only cost that's like this yet, all the
16 silliness that goes on in proxy solicitations. You have
17 Congress's issue de jure that needs disclosure. All of
18 this is just -- adds up and at some point, if you're not
19 in Mr. Newell's company's situation and you've got a
20 choice and you vote with your feet and you say, "I don't
21 need to put my head in that lion's mouth," and you go and
22 you become a private company.

23 So Mr. Hinman, in a way, you're in a
24 competitive market and you've got -- you're competing to
25 keep these companies public or to make them go public,

1 and there are a lot of market forces out there that are -
2 - are pulling the other way. Now, God knows you've got
3 more people pulling you in different directions, and I
4 don't envy your job. But I mean that is -- at the end of
5 the day, there are market forces that are going to drive
6 companies, like promising companies like Mr. Newell's --
7 if not this particular company, other ones -- to be
8 private or to thumb their nose at being public and just
9 leave.

10 MR. HINMAN: Totally understand that, and we
11 also understand that the biotech, sir, is one of the few
12 sectors where the public markets still are attractive
13 enough that they're going to, you know, bear the burdens.
14 But totally appreciate that we're putting a lot of
15 straw's on the camel's back, and it's not so much fun to
16 be a camel anymore.

17 MR. REARDON: No, and --
18 (Laughter.)

19 MR. HINMAN: And we're very cognizant of that
20 and we are prioritizing --

21 MR. REARDON: We're trying to be good camel
22 drivers.

23 (Laughter.)

24 MR. HINMAN: We are trying to prioritize things
25 that make it a little bit more attractive. You know,

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1 there's an assortment of issues that we all recognize.
2 It's not just the regulatory burden that have sort of
3 changed the landscape on who's going public and when, and
4 the attractiveness, relative attractiveness of that
5 versus private capital. But we get it, and you'll see in
6 our rulemaking agenda and the priorities that we are --
7 we're focused on the -- on the topic.
8 MR. REARDON: Thank you.
9 CO-CHAIR HANKS: Any more questions for our
10 experts? Well, thank you very much. It's been very
11 useful. Thank you.
12 MR. NEWELL: Thank you so much for your time
13 and attention today.
14 MR. COMBS: Thanks.
15 CO-CHAIR GRAHAM: Okay. The next thing on our
16 agenda is the final report of this committee. The first
17 iteration of this advisory committee was established by
18 the SEC in 2011, and the committee has been renewed for a
19 total of three two-year terms. Back in 2011, small
20 businesses had fewer options for raising capital. If a
21 company wanted to conduct a widespread offering of
22 securities using general solicitation, frequently it
23 would have to go public and register the offering with
24 the commission. Businesses not needing to engage in a
25 general solicitation most commonly would have conducted

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1 an offering under Rule 506(b), which, as I think most of
2 us know, is (inaudible) 506.
3 We seem to be leaving some -- losing some
4 folks. Is -- was there --
5 CO-CHAIR HANKS: They just need coffee.
6 CO-CHAIR GRAHAM: They just need coffee. Okay.
7 Then they're going to need a bio break, but --
8 (Laughter.)
9 CO-CHAIR GRAHAM: 506(b), which limits
10 purchasers who are accredited investors to no more than
11 35 sophisticated investors. This meant there were
12 limited options for businesses that were not ready to
13 conduct a registered offering and did not have access to
14 accredited or sophisticated investors.
15 Since 2011, however, legislative changes and
16 SEC rulemakings have led to significant changes. The
17 exempt offering framework has been expanded to allow new
18 capital-raising avenues for small businesses and updated
19 to reflect the realities of life in the internet age.
20 The recommendations put forward by the advisory committee
21 over the past six years played a role in many of the
22 changes leading to the current framework.
23 In December 2016, Congress added a provision to
24 the Securities Exchange Act that establishes in statute a
25 similar advisory committee on a permanent basis, the SEC

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1 Small Business Capital Formation Advisory Committee. We
2 have drafted a final report to memorialize the 17
3 recommendations made by the committee and to identify
4 areas we recommend for continued focus of the commission,
5 the SEC staff and the future Small Business Capital
6 Formation Advisory Committee.
7 I think all of you have had an opportunity to
8 review the draft report that was circulated. I'd like to
9 take your comments now. As everyone should know, one of
10 our members, namely Patrick, has submitted a set of
11 comments in writing. Does -- did everyone receive a
12 copy? Did everyone receive copies of both documents?
13 (No response.)
14 CO-CHAIR GRAHAM: Okay. Open to suggestion,
15 but I think that what might make some sense is if we just
16 page through the report. And I would suggest that we use
17 the mark-up that Patrick supplied, (inaudible) make all
18 of our lives easier as we kind of go along.
19 Okay. So we start out with the history of the
20 committee. We list the recommendations, and I think if
21 we get to some comments on page 6. Does anyone have any
22 comments before page 6?
23 (No response.)
24 CO-CHAIR GRAHAM: Okay. First -- first comment
25 is the addition of the lead-in paragraph to part three of

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1 -- I am disinclined to include this for two reasons. I
2 don't think -- you know, I don't think we need it, and I
3 haven't read it. So if -- anyone else have any viewpoint
4 on that?
5 (No response.)
6 CO-CHAIR HANKS: I guess they haven't read it
7 either.
8 CO-CHAIR GRAHAM: Okay. Unless -- unless I
9 hear any objection, let's -- let's not include that. I
10 think the addition of the word "the" further down and
11 deleting "a" I think is fine. No disagreement there?
12 (No response.)
13 CO-CHAIR GRAHAM: That gets us to page 7. Any
14 comments?
15 (No response.)
16 CO-CHAIR GRAHAM: What about page 8?
17 (No response.)
18 CO-CHAIR GRAHAM: Nine?
19 MR. YADLEY: Steve?
20 CO-CHAIR GRAHAM: Yes.
21 MR. YADLEY: So sort of the carryover from page
22 9 -- and first of all, thank you very much for taking the
23 care you did with Sara to draft this report. It made it
24 a lot easier for us. I was making notes in advance of
25 the meeting, and you did a terrific job of capturing what

1 we talked about and one of the points --

2 CO-CHAIR HANKS: Actually, the staff did a

3 brilliant job (inaudible).

4 MR. YADLEY: And the staff did a brilliant job.

5 CO-CHAIR GRAHAM: I was going to say we, in

6 turn, thank Julie and Sebastian, but --

7 MR. YADLEY: I was -- I was -- that was my --

8 that was my handoff.

9 (Laughter.)

10 MR. YADLEY: So one of the things that was

11 noted was that we did not have a mandate, as did the

12 earlier Small Business Committee, to actually create a

13 report, and that was our focus. We had specific things

14 to do. And I think our being unharnessed has led to a

15 really robust series of discussions, and it's important

16 that we now do a report because it is a little bit

17 humbling to see all the things we talked about. Some of

18 the things that made their way into the JOBS Act were

19 presaged by what we did working with the staff.

20 It almost reminds me of Sarbanes-Oxley, where,

21 had the times been different, I think the SEC would have

22 -- would have implemented most of the things that

23 Congress told them to do and would have done a better

24 job. And certainly there are parts of the JOBS Act that

25 we commented on, including crowdfunding, where I think

1 the expertise and continuity of the staff and input from

2 informed folks like us might have led to a better result.

3 But in any event, thanks, Sebastian and Julie and Betsy

4 and everyone for that.

5 But to page 9 and the carryover on page 10, I

6 do have some wording suggestions --

7 CO-CHAIR GRAHAM: Yes.

8 MR. YADLEY: -- if that's okay. I --

9 unfortunately, Irma unbundled me from my computer and I

10 was untethered and didn't have access to this until

11 yesterday. But at the top of page 10, "undertaking small

12 transactions which make them unattractive to registered

13 brokers;" and (b), I would leave (b) the way it was

14 initially and delete "and the complexities" and so on.

15 And then after the word "broker," and a period would

16 include the following: "We further believe that the data

17 is misleading," or we could say that "the numbers are

18 understated due to," and then pick up "widespread

19 noncompliance by those who should be registered."

20 And then before the last sentence that Patrick

21 added, I would say, "Therefore, we believe there is" --

22 my own writing. Let me come back to that. But the first

23 part, and it's in my scribble, but I can write it down,

24 but it --

25 CO-CHAIR GRAHAM: Okay.

1 MR. YADLEY: I don't know if you got that, or

2 Julie, you (inaudible) understood --

3 CO-CHAIR GRAHAM: Okay, thank you for that.

4 The last sentence that was added, also (inaudible), et

5 cetera, I'm not sure if I agree with that. And this --

6 this whole portion of this paragraph basically relates to

7 the fact that only 13 percent of Reg D offerings reported

8 using a financial intermediary, and I'm -- I don't think

9 that this last sentence has anything to do with that.

10 CO-CHAIR HANKS: But I think it's also a

11 judgment that this committee didn't actually make at the

12 time we discussed it, so I would leave it out for that

13 reason.

14 CO-CHAIR GRAHAM: Any disagreement?

15 MR. REARDON: I obviously put it in there

16 because I think it's a factually correct statement, but I

17 will defer to your judgment. It's not something I'm

18 going to beat my chest over.

19 CO-CHAIR GRAHAM: Fair enough. Thank you.

20 Footnote 19, I -- typically we don't include individual -

21 - or the views of individual members, so I wouldn't have

22 that -- I would not include that footnote.

23 Page 11? Yeah.

24 MR. YADLEY: Just the very top, the ACSEC. I

25 would include the word "first" after that. Just a small

1 suggestion.

2 CO-CHAIR GRAHAM: "First made recommendations"?

3 MR. YADLEY: Yeah.

4 CO-CHAIR GRAHAM: The new language, the added

5 language in the next paragraph, I'm fine with that. Does

6 anyone have a different view?

7 MR. YADLEY: Just capitalize "committee" in

8 that if we include it.

9 CO-CHAIR GRAHAM: Got it.

10 MR. YADLEY: Footnote 25.

11 CO-CHAIR GRAHAM: Mm-hmm.

12 MR. YADLEY: The second sentence, "This letter

13 addresses persons assisting in the transfer in control of

14 smaller businesses as M&A brokers but does not provide

15 any relief for capital raising by such companies." In

16 other words, I think the footnote is good to point out

17 that the division did provide very helpful action here,

18 but it's not in the context of capital raising. So the

19 letter addresses persons assisting in the transfer of

20 control of smaller businesses as M&A brokers but does not

21 provide any relief for capital raising by smaller public

22 companies.

23 CO-CHAIR GRAHAM: Right. Got that, Julie?

24 MS. DAVIS: It would say, "This letter

25 addresses persons assisting in the transfer and control"?

1 MR. YADLEY: "Transfer of control."
 2 MS. DAVIS: "Transfer of control."
 3 MR. YADLEY: "Of smaller businesses."
 4 MS. DAVIS: Okay. Thank you. And then after
 5 M&A brokers, "but does not provide any relief for" --
 6 MR. YADLEY: "Capital raising."
 7 MS. DAVIS: -- "capital raising by smaller
 8 companies"?
 9 MR. YADLEY: Yeah.
 10 CO-CHAIR GRAHAM: Okay. That takes us to page
 11 12. I wouldn't designate us here as the outgoing
 12 committee. We're just the committee (inaudible), so
 13 we'll continue with that.
 14 Thirteen?
 15 MS. TIERNEY: I'm sorry, if we could just go
 16 back to the accredited investor section. I think it
 17 might be helpful -- I don't have specific wording, but
 18 just a concept. You know, one of the things that we
 19 spoke about with Chair White was this potential concept
 20 that there should be investment limitations put on top of
 21 accredited investors if the definition was expanded, and
 22 I think we felt that that was the wrong way to go. I
 23 wouldn't mind seeing some language in here that
 24 highlighted the fact that we'd like to see the definition
 25 expanded without any limits put on the actual amount

1 people can invest, because I think that that's counter --
 2 CO-CHAIR GRAHAM: Okay, let's see. Which --
 3 what page are you on, Annemarie?
 4 MS. TIERNEY: Twelve, in the paragraph --
 5 CO-CHAIR GRAHAM: (Inaudible) 11?
 6 MS. TIERNEY: -- that says we support the
 7 expansion of the definition to take into account measures
 8 of sophistication. Maybe in that paragraph just add some
 9 language that, you know, we did not support the idea of
 10 limiting the investment -- halving the investments
 11 available to be made by people in the expanded
 12 categories.
 13 CO-CHAIR GRAHAM: I don't disagree with that,
 14 but I'm still looking for what you are suggesting that we
 15 add in.
 16 MS. TIERNEY: In the "our committee" paragraph,
 17 the outgoing (inaudible), supports the expansion --
 18 "expanding the definition to take into account measures
 19 of sophistication." It's the second full paragraph on
 20 page 12.
 21 CO-CHAIR GRAHAM: Yeah. Oh, so you kind of
 22 tricked me. You're right where we were.
 23 MS. TIERNEY: That's right.
 24 (Laughter.)
 25 CO-CHAIR GRAHAM: Okay.

1 MS. TIERNEY: And I wasn't trying --
 2 CO-CHAIR GRAHAM: I thought you were actually
 3 going back. Okay. It's okay. Got it.
 4 MS. TIERNEY: No, no, no. I wasn't trying to
 5 trick you. You said page 13 and I said no, hold on.
 6 (Laughter.)
 7 CO-CHAIR GRAHAM: Thank you for --
 8 MS. TIERNEY: I'm being very transparent.
 9 CO-CHAIR GRAHAM: Thank you for your help,
 10 Annemarie.
 11 MS. TIERNEY: You're very welcome, sir. Happy
 12 to help.
 13 (Laughter.)
 14 CO-CHAIR GRAHAM: Okay. Did you get that,
 15 Julie?
 16 MS. DAVIS: Got a concept, no words.
 17 MS. TIERNEY: Actually, I can -- I'll send you
 18 a sentence I was circulating.
 19 CO-CHAIR GRAHAM: Okay.
 20 MS. DAVIS: Great.
 21 CO-CHAIR GRAHAM: So, page 13? I think the
 22 changes are okay. And 14, a -- I'm disinclined to add
 23 the new language. I recall noting this in April.
 24 Anybody else?
 25 MR. VERRET: I support the language, although I

1 would strike -- I would -- my suggestion would be to
 2 strike the word "psychometric", and I say all that
 3 knowing that I wasn't there and I'm a new addition. So,
 4 for consideration, I would strike the word "psychometric"
 5 but otherwise keep the existing language, and I would
 6 suggest adding an acknowledgment that in order for the
 7 SEC to meet its obligation under Business Roundtable v.
 8 SEC to conduct economic analysis, it needs to determine
 9 that mandatory disclosure changes are material.
 10 CO-CHAIR GRAHAM: Again, my first question is
 11 did we say this on April 13th?
 12 CO-CHAIR HANKS: Yeah, we're only saying it
 13 now. I mean, I would support the thought, for sure, but
 14 I think as a summary of what we already decided and
 15 recommended, we didn't do that. We maybe should. If we
 16 were to do it, we could do it now, but that would
 17 actually have to be a separate discussion.
 18 MR. YADLEY: I think it's a good thought. I
 19 would be inclined to delete the first sentence and start
 20 the second sentence with, "As part of this initiative, we
 21 recommend the commission conduct a study." And then at
 22 the very end, on the last line, "improved over the years"
 23 and strike the rest of that and state that such a study
 24 could enhance the commission's ability to make disclosure
 25 more relevant to investors so that it -- the general

1 thought is I think correct, and we did talk about it, and
2 as was noted earlier, we've always asked for more data.
3 And our absent member from California, that was one of
4 the things he included in his statement.

5 CO-CHAIR GRAHAM: Okay. Fair enough.
6 Catherine?

7 MS. MOTT: (Inaudible) agree. I'd just say I
8 feel comfortable with the way Gregory has structured it.

9 CO-CHAIR GRAHAM: Okay.

10 MS. DAVIS: Could you -- could you just read it
11 again, Greg? Thanks. Are you talking about the first
12 sentence that's, "What is" --

13 CO-CHAIR GRAHAM: Your microphone.

14 MS. DAVIS: "What is appropriate"?

15 MR. YADLEY: Yeah, what is (inaudible). I'm
16 sorry. Yeah, "What is appropriate," in the paragraph
17 with "as part of this initiative, we recommend" --

18 MS. DAVIS: Got it.

19 MR. YADLEY: On the last -- and then on the
20 last line, Julie, after the word "and," cross out the
21 rest of that and substitute "such a study would enhance
22 the commission's ability to make disclosure more relevant
23 to investors."

24 MS. DAVIS: Got it. Thank you.

25 CO-CHAIR GRAHAM: And did you get J.W.'s?

1 MR. REARDON: Yeah, all you're doing is --
2 well, first of all, I didn't understand that we were
3 limited in -- I thought this point here, we were
4 considering these things. But it wasn't my intent to
5 pull the rug out from anybody -- under anybody by putting
6 new stuff in here. I thought we were open to new stuff.
7 But --

8 MS. TIERNEY: Can we have a section at the end
9 for additional proposals to be --

10 MR. REARDON: Yeah, I think -- I think you can.
11 I think there's -- Julie, don't the bylaws provide for a
12 separate section if differing opinions, in the bylaws of
13 this committee? So I think you can have -- or maybe
14 Sebastian knows.

15 MR. GOMEZ: Well, this report is entirely
16 voluntary, so it's not something that's required. So you
17 as a committee get to set forth what, if anything, you
18 want to include. In fact, even the whole point of the
19 report itself is something that it's a decision of the
20 committee, and none of it is required. So I think there
21 is a lot of flexibility.

22 MR. REARDON: None of it's required. And to
23 the extent they don't -- the committee as a body doesn't
24 incorporate any of these, I'm free to send my own letter
25 that says -- I or anybody else can join me in sending --

1 MR. VERRET: Maybe a friendly minute to the --
2 your language "and meet its obligation under BRT v. SEC
3 to conduct economic analysis and determine materiality."
4 That'd be --

5 MR. YADLEY: I'm going to wear a tie just like
6 yours next time.

7 (Laughter.)

8 MS. DAVIS: So "and to meet its obligation
9 under BRT v. SRC, or SEC, to conduct economic analysis."
10 Was there anything after that?

11 MR. VERRET: "And determine materiality."

12 CO-CHAIR GRAHAM: Okay, anything else on 13?
13 Actually, that was 14. Anything else?

14 (No response.)

15 CO-CHAIR GRAHAM: All right. Fifteen. I guess
16 a couple of things. We have -- let's start with pruning
17 the proxy process. I'm not sure, you know, to what
18 extent we have spent time discussing this particular
19 issue. It may be a valid point, but we -- I don't think
20 we've spent developing any kind of consensus with respect
21 to it.

22 MR. YADLEY: Good points but we haven't talked
23 about it.

24 CO-CHAIR HANKS: Say, put it on the agenda for
25 the next committee.

1 MR. GOMEZ: That's correct.

2 MR. REARDON: -- sending -- making these same
3 points if you choose not to do it. So that remains a
4 possibility that I'll just do it myself, or if anybody
5 cares -- is -- anybody is wise enough to join me --
6 (Laughter.)

7 MR. REARDON: -- to -- in doing that. I will
8 probably just do that myself with anyone else who cares
9 to join me. But if you want to take it out, that's fine.

10 CO-CHAIR GRAHAM: I think it's -- I'm happy to
11 hear the views of others, but I'm inclined to take out
12 these last few paragraphs because we haven't spent time
13 to try to develop a consensus. And as far as, you know,
14 coordination down the road, I think these are good
15 points, but I think we're more into policy
16 recommendations and less into governance. (Inaudible)
17 suggestions that we as individuals can certainly make,
18 and I think they're probably valid suggestions, but I'm
19 not sure if I want to put this in the committee report.

20 So (inaudible) open to other comments.

21 CO-CHAIR HANKS: I agree with that. I would
22 look forward to Patrick's letter, which may be even more
23 entertaining when it's under his own name only.

24 MR. REARDON: I can make it as entertaining as
25 you want.

1 (Laughter.)
 2 CO-CHAIR GRAHAM: Okay, that gets us to page
 3 16. Annemarie?
 4 MS. TIERNEY: In the secondary market liquidity
 5 section, did the committee also recommend the adoption of
 6 a new second trading exemption that ultimately was sort
 7 of along the lines of what happened with 407? I thought
 8 that you made a recommendation to adopt a new safe harbor
 9 for -- that would be worth noting here too.
 10 MR. GOMEZ: Annemarie, will you send us some
 11 language for that?
 12 MS. TIERNEY: Of course.
 13 MR. YADLEY: Stephen?
 14 CO-CHAIR GRAHAM: Yes.
 15 MR. YADLEY: The additional paragraph at the
 16 top of page 16, if you're inclined to include that --
 17 CO-CHAIR GRAHAM: I was not inclined to include
 18 that.
 19 MR. YADLEY: Okay.
 20 MS. TIERNEY: (Inaudible), that was my
 21 favorite.
 22
 23
 24 CO-CHAIR GRAHAM: Eighteen?
 25 (No response.)

1 CO-CHAIR GRAHAM: Okay.
 2 (Laughter.)
 3 CO-CHAIR GRAHAM: All right. Well, again,
 4 thank -- thank you all for reading this. Thank you all
 5 for your participation and your contribution to the 17
 6 recommendations that have been made over the years and
 7 those recommendations that reflect kind of our
 8 participation in moving the ball forward, and also those
 9 recommendations where we think work still needs to be
 10 done.
 11 So I guess what I would do now is entertain a
 12 motion that we adopt this report as amended.
 13 MS. TIERNEY: So moved.
 14 MR. REARDON: So moved. Second.
 15 CO-CHAIR GRAHAM: Okay. Further discussion?
 16 (No response.)
 17 CO-CHAIR GRAHAM: Okay. All those in favor?
 18 (Chorus of ayes.)
 19 CO-CHAIR GRAHAM: All those opposed?
 20 MR. VERRET: Just register an abstention, just
 21 because I'm late to the party and wasn't part of all the
 22 discussions. But I admire the committee's work a great
 23 deal, so --
 24 CO-CHAIR GRAHAM: Thank you, J.W., and I would
 25 expect nothing less than an abstention from someone who

1 just got here. So, thank you. So the report is adopted.
 2 Is that the last thing in this morning's
 3 agenda?
 4 MS. DAVIS: Yes.
 5 CO-CHAIR GRAHAM: All right. Then I think we
 6 can have a lunch break early.
 7 MS. DAVIS: Yeah.
 8 CO-CHAIR GRAHAM: Thank you.
 9 MS. DAVIS: So we'll reconvene at 2:00. That's
 10 when the afternoon agenda says that we'll reconvene. So
 11 you have time for lunch and we'll see you back here then.
 12 (Whereupon, at 11:35 a.m., a luncheon recess
 13 was taken.)
 14 A F T E R N O O N S E S S I O N
 15 CO-CHAIR GRAHAM: Okay, let's think about
 16 getting started. Sebastian, I think we have a returning
 17 quorum.
 18 MR. GOMEZ: We do, if you count the people
 19 getting a --
 20 CO-CHAIR GRAHAM: Over there.
 21 (Laughter.)
 22 MR. GOMEZ: -- few refreshments.
 23 CO-CHAIR HANKS: We'll include them.
 24 CO-CHAIR GRAHAM: Okay, everyone. Thanks for
 25 coming back. Hope you had a good lunch. Now it's time

1 for 701 and I'll pass -- I'll pass the baton to Sara.
 2 CO-CHAIR HANKS: All right, thank you. It's a
 3 shame we don't have a very big audience, live audience,
 4 because this is really a very important issue for small
 5 companies. Securities Act Rule 701 provides an exemption
 6 from registration from securities -- for securities
 7 issued by non-reporting companies pursuant to a
 8 compensatory benefit plan for employees, directors,
 9 general partners, trustees, officers, or certain
 10 consultants. Issuers that sell more than five million of
 11 securities in a 12-month period in reliance on Rule 701
 12 have to provide investors with recurring specified
 13 disclosure, including detailed financial statements.
 14 Many growing companies compete for talent by
 15 granting compensatory stock options or other awards.
 16 With companies staying private longer and growing to
 17 higher valuations, there have been various legislative
 18 amendments proposed to expand and modernize Rule 701,
 19 which was last amended in 1999. The CHOICE Act, which
 20 passed the House of Representatives in June of this year,
 21 would have raised the five million threshold -- that's
 22 the threshold beyond which you have to provide the extra
 23 information -- for sales in a 12-month period to 20
 24 million. This week, the Senate approved the Encouraging
 25 Employee Ownership Act, which has already been approved

1 earlier this year by the House, bumping up the point at
 2 which specified disclosure is required to 10 million, to
 3 be adjusted by inflation. Hopefully the President will
 4 sign that at some point soon.

5 Given the importance of incentive and award
 6 compensation for many private companies, we thought it
 7 would be useful to explore Rule 701 and whether there are
 8 any updates or other amendments that might be warranted.

9 We're joined today by an expert in this area, Christine
 10 McCarthy, a partner who focuses on compensation and
 11 benefits in the Technology Companies Group at the law
 12 firm Orrick. Christine's practice focuses on equity and
 13 executive compensation plans and programs for private and
 14 public companies with a particular focus on late-stage
 15 public -- private companies.

16 Christine is joined by Steve Miller, the chief
 17 financial officer of Warby Parker, a privately held
 18 stylish eyeglass company that offers designer frames for
 19 \$95. Certified as a B corporation since 2011, Warby
 20 Parker has been growing significantly over the last few
 21 years, and so we're looking forward to hearing about
 22 their experiences using Rule 701.

23 Christine and Steve, thank you very much, and
 24 I'll hand it over. Christine, you're going first?

25 MS. MCCARTHY: Great. Thank you very much, and

1 thank you very much for having us here today. We're
 2 really excited to talk to you about Rule 701. It's an
 3 issue that's very near and dear to my heart, and we'd
 4 like to share with you some ideas we have around ways in
 5 which Rule 701 can be potentially improved.

6 So I'd like to just start with a high-level
 7 overview of Rule 701 just to set the -- set the stage.
 8 Rule 701 is an exemption from the registration
 9 requirements of Section 5 of the Securities Act for
 10 offers and sales of securities to certain individuals in
 11 compensatory transactions pursuant to compensatory
 12 benefit plans and contracts.

13 Companies that can use Rule 701 include
 14 companies that are not subject to the reporting
 15 requirements of the Exchange Act and companies that are
 16 not investment companies.

17 Rule 701 is used to issue securities to
 18 employees, consultants, officers, advisers, directors,
 19 general partners and trustees of issuers, issuers'
 20 parents, majority-owned subsidiaries, and the majority-
 21 owned subsidiaries of the issuers' parents. Those
 22 service providers can also receive securities if they are
 23 former service providers, so long as the offer was made
 24 to them while they were employed by or providing services
 25 to the issuer. And family members of those service

1 providers may also receive securities pursuant to 701
 2 from those service providers pursuant to gift or domestic
 3 relations orders.

4 What is not permitted under 701 -- this is
 5 important because this comes up in a number of ways in
 6 our talk later today. Rule 701 is not available for
 7 resales of securities. Rule 701 is not available for
 8 plans or schemes that have the purpose of circumventing
 9 the compensatory purposes of Rule 701. And Rule 701 is
 10 not available for plans or schemes that technically
 11 comply with Rule 701 but are really aimed at avoiding the
 12 registration requirements of the Securities Act.

13 Rule 701 has several -- two limits: a hard-cap
 14 limit and a soft-cap limit. We refer to the hard-cap
 15 limit as the hard-cap limit because that's the limit in
 16 the number of -- total number of securities that a
 17 company can issue in a 12-month period. Pursuant to the
 18 hard-cap limit, a company in any consecutive 12-month
 19 period can issue securities up to the greater of \$1
 20 million in value, 15 percent of the total assets of the
 21 company, or 15 percent of the outstanding securities of
 22 the company.

23 It's important to note, too, that under Rule
 24 701 there is no integration with other securities
 25 exemptions. So only shares and securities that are

1 issued under Rule 701 are counted against the limit.

2 The second limit under Rule 701 we refer to as
 3 the soft-cap limit. Under the soft-cap limit, if an
 4 issuer sells securities in excess of \$5 million in any
 5 12-month period, the issuer is required to provide
 6 additional disclosure to any recipient of a security
 7 under Rule 701 during that 12-month period. That
 8 additional disclosure includes -- it includes material
 9 terms, a summary of the material terms of the plan, it
 10 includes risk factors, and it includes certain financial
 11 disclosure. The financial disclosure that's required is
 12 the financial disclosure that's required under Reg A, and
 13 it must be current within 180 days of the sale pursuant
 14 to which the disclosure is provided.

15 Those changes -- before we get into the
 16 specific changes, we'd like to talk a little bit about
 17 the role of equity compensation in private company growth
 18 and development, why it's so important to private
 19 companies, and how 701 factors in.

20 Compensating employees and consultants with
 21 equity has become an invaluable tool for many private
 22 companies in the United States and is really important
 23 and critical for companies to have this tool in order to
 24 hire the talent that they need to hire to support the
 25 growth and development of the company.

1 At the earliest stages, some companies don't
2 have the cash resources to pay service providers in cash,
3 and oftentimes they'll look for ways to pay service
4 providers either primarily or exclusively in equity. At
5 later stages, equity compensation is critical in order
6 for those companies to hire the talent they need to
7 support the development of the company.

8 Many private companies, particularly those at
9 the earliest stages, don't have the resources to comply
10 with rules that are complicated or overly burdensome or
11 costly to administer. The lack of resources available to
12 private companies can create inadvertent compliance
13 errors where there's complexity or cost associated with
14 complying with rules.

15 Given the importance of equity compensation to
16 private companies and the development of private
17 companies, it's absolutely critical that the rules that
18 are in place for these private companies are rational,
19 not unduly complicated, and not too difficult to comply
20 with.

21 MR. MILLER: Yeah, sure. Thank you for having
22 me here. I'm the CFO of Warby Parker, which is a startup
23 company that has been around seven years. We're somewhat
24 mature in our development, but we still like to think of
25 ourselves very much as a startup. I've had a few various

1 startup experiences, which I can talk about. I worked at
2 a venture capital fund called Flatiron Partners. I
3 worked for a financial data analytics firm called
4 Majestic Research. I worked for a company called
5 GameLogic, and now I am at Warby Parker. So I've been in
6 the startup world in a number of different contexts -- as
7 an investor and as an operator -- and I can say that
8 equity compensation has always been a meaningful tool
9 that a startup company can use to attract and retain
10 talent. One of the hardest things that you have to
11 confront as a startup company is really competing for
12 talent and convincing people to come and work for your
13 company, and one of the tools that we have which has been
14 quite useful is equity and awarding stock options to
15 employees.

16 So this topic is certainly near and dear to my
17 heart as a person who's responsible for our equity
18 compensation programs. Christine has helped demystify
19 the topic for us, and one of the bigger issues that we've
20 had as a fast-growing company is actually understanding
21 how to interpret 701 and make sure that we're in
22 compliance with it. So I think that there are a few
23 things to keep in mind.

24 One, from my perspective, one is the difficulty
25 and somewhat ambiguous nature of actually understanding

1 how to interpret the rule as a company who's trying to do
2 many things all at the same time. That's number one.
3 And number two, it's then making sure once you do
4 understand how the rule actually operates, that you can
5 operate within it and still attract and retain the right
6 type of talent.

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10 MS. MCCARTHY: The first change that we'd like
11 to talk about is a proposal to remove the requirement
12 that consultants be natural persons. So Rule 701 is
13 available to consultants and advisors only if those
14 consultants and advisors are natural persons, they
15 provide bona fide services to the issuer, its parents,
16 majority-owned subsidiaries, or the majority-owned
17 subsidiaries of the issuer's parent, and the services are
18 not in connection with the offer and sale of securities
19 in a capital-raising transaction and do not directly or
20 indirectly promote the sale of those securities and
21 maintaining a market in those securities.

22 Private companies hire consultants to perform
23 services for the company routinely. It's very, very
24 common, particularly at the early stages, for private
25 companies to hire consultants who are providing services

1 that employees would normally hire -- perform. For
2 example, it's very common for early-stage companies to
3 hire consultants -- their CFOs as consultants at the
4 earliest stages simply because they don't have the
5 resources to hire people full-time. So it's very
6 important for companies to be able to hire these
7 consultants and to be able to effectively compensate
8 these consultants.

9 Many of these consultants choose to organize
10 themselves in the form of an entity, even if they are
11 just one individual providing services. The reason for
12 that is it's efficient from a tax perspective and it
13 protects them from liability. So it's very, very common
14 for us to see companies engaging individuals who are
15 providing employee-like services to private companies in
16 an entity form, and having the rule structured so that
17 it's not permitted to grant equity under Rule 701 to
18 someone who's providing services as an entity is
19 problematic. It causes companies to have to jump through
20 hoops, effectively, in order to figure out ways to get
21 these individuals that are providing services to the
22 company equity.

23 In the preamble to the 1988 release, when Rule
24 701 was first adopted, there was some concern expressed
25 about including consultants at all in Rule 701. And the

1 SEC indicated that it thought this concern was unfounded.
 2 The concern was that including consultants as available
 3 recipients under Rule 701 might cause Rule 701 to be
 4 abused for non-compensatory purposes. So in 1988, as I
 5 said, the SEC indicated they didn't agree with that
 6 conclusion, thought it was not warranted, and adopted the
 7 rule with a broad-based definition of consultant that did
 8 not have any reference to whether or not that consultant
 9 was a natural person or entity.

10 In 1999, when Rule 701 was amended, again, the
 11 preamble to the 1999 release talked about concern related
 12 to abuse of 701 where equity was granted to consultants
 13 in a manner which people felt was abusive as it was non-
 14 compensatory. As a result of that, the SEC decided at
 15 the time to structure the rule so that consultants and
 16 advisors had to be natural persons in order to receive
 17 equity under Rule 701.

18 In looking at that now, we propose reverting to
 19 the original rule, which doesn't require consultants to
 20 be natural persons. It seems that there's no clear
 21 rationale expressed in the 1999 release for adding the
 22 requirement for natural -- for natural persons to receive
 23 equity under Rule 701. The only reference in the release
 24 was to this concern related to the abuse of Rule 701 for
 25 non-compensatory purposes, and we think that excluding or

1 including consultants on the basis of their status as a
 2 natural person or entity is not directly related to that
 3 goal of avoiding abuse of Rule 701 for non-compensatory
 4 purposes.

5 We also feel that if there is concern related
 6 to the abuse of Rule 701 for non-compensatory purposes,
 7 that the more appropriate avenue is to enforce the rule
 8 that already exists, that prohibits the use of Rule 701
 9 for non-compensatory purposes.

10 MR. MILLER: Just to provide some color on the
 11 consultant topic, we've worked with a range of
 12 consultants at my current company and also at my previous
 13 companies to help us get up to speed on a range of
 14 different items like supply chain analysis, general
 15 public relations, legal services, temporary CFO services,
 16 and the like. So the use of consultants, it's not really
 17 confined to one specific topic or area. It's really
 18 dependent on what the particular company needs.

19 MS. MCCARTHY: The second item that we'd like
 20 to talk about is eliminating what we're referring to as
 21 the hard-cap limit. When Rule 701 was first adopted, it
 22 was adopted pursuant to Section 3(b) of the Securities
 23 Act, which authorized the SEC to adopt an exemption up to
 24 a \$5 million threshold such that the exemption could be
 25 created so long as it had a limit on the total number of

1 securities that could be issued in reliance on that
 2 exemption of \$5 million.

3 In 1988, the SEC, pursuant to this authority,
 4 adopted Rule 701. In 1996, Congress enacted the National
 5 Securities Market Improvement Act of 1996, which gave
 6 Congress the -- which gave the SEC the authority to
 7 provide exemptive relief in excess of the \$5 million
 8 limit and effectively remove the \$5 million mandatory
 9 limit, and in the legislative history, encouraged the SEC
 10 to use that authority to remove the limit from Rule 701.

11 Rule 701 was amended in 1999, pursuant to its
 12 current form. In the preamble to the 1999 release,
 13 pursuant to which Rule 701 was amended, the staff stated
 14 that the increase in the limit was made to provide
 15 issuers with the flexibility they need without creating
 16 opportunities for abuse. Again, there seems to be a
 17 focus on preventing opportunities for abuse where Rule
 18 701 could be used for non-compensatory purposes, and it
 19 seems that the limit was retained in order to prevent
 20 abuse of Rule 701 for non-compensatory purposes.

21 Compliance with the hard-cap limit requires
 22 ongoing analysis and it requires a substantial amount of
 23 work on the part of companies, and there's no real clear
 24 rationale for the limit. The limit, again, similar to
 25

1 the natural person requirement for consultants, isn't
 2 directly aimed at preventing abuse, abusing Rule 701 for
 3 non-compensatory purposes. The fact that there's a limit
 4 has no impact on whether companies would use Rule 701 for
 5 non-compensatory purposes. It limits the total amount of
 6 securities that could be issued pursuant to Rule 701.

7 We feel the limit is not directly related to
 8 the purpose of the -- of -- that was trying to be
 9 achieved by the SEC in adopting the limit, and it doesn't
 10 otherwise curb abuses of Rule 701. Again, we think that
 11 if the desire is to curb abuse of non-compensatory
 12 issuances, that the appropriate approach to that is to
 13 enforce the rules that currently exist that do not allow
 14 the use of Rule 701 for non-compensatory purposes.

15 (Inaudible) a little bit about the challenges
 16 in complying with the rule?

17 MR. MILLER: Sure. So we grant stock options
 18 on a regular basis throughout the year. We currently
 19 have four board meetings, and typically at each board
 20 meeting we approve stock option grants and then we might
 21 approve outside of each board meeting option grants
 22 another four times a year. And every time that we put
 23 forward a round of grants, we have to understand whether
 24 or not we're going to bump up against the \$5 million
 25 limit. Previously, we did that using a spreadsheet and

1 we were never quite sure if the numbers were accurate,
2 and we weren't entirely sure how to understand the
3 nuances of the law.

4 It's only recently that we actually had the
5 resources to put in place a legal department, and we've
6 implemented a tool called eShares, which has automated
7 the process of actually doing that 701 check, which has
8 made my life a lot easier; it's made our legal team's
9 lives a lot easier and my controller's life a lot easier.

10 It's still a challenge, though, because you want many
11 things as a startup company, and one of the biggest
12 things that you want is flexibility to make decisions,
13 and hiring decisions are your most important. And what
14 we've started to do is particularly in the context of
15 equity and equity grants, make sure that before we make a
16 hiring decision, particularly of a senior executive, that
17 we're going to be in compliance with 701. And it's an
18 added step in the decision chain that we didn't used to
19 have to go through, so it just adds complexity to the
20 process from a few different -- from a few different
21 aspects.

22 MS. MCCARTHY: The next item we'd like to talk
23 about is adopting a rule that excludes material
24 amendments from the calculation of the Rule 701 limit.
25 Rule 701 doesn't explicitly or expressly address

1 amendments to securities that were previously issued
2 under Rule 701. However, C&DI 271.10 requires issuers to
3 count stock options that are repriced as new grants and
4 new sales under Rule 701 as of the date of the repricing.

5 We recommend adopting a rule that clarifies that
6 material amendments to any security that was previously
7 issued under Rule 701 does not result in a new grant or a
8 new sale for purposes of Rule 701.

9 The repricing rule itself can cause companies
10 to exceed the hard-cap limit and the soft-cap limit at a
11 time when no additional securities are being issued.
12 There is no new grant. All that's happening at that time
13 is the stock option exercise price is being reset in
14 order to continue to assure the compensatory purpose of
15 the security that was issued.

16 Requiring repriced options to be counted
17 against the limit at the time of the repricing can often
18 cause the limit to be exceeded because oftentimes what
19 happens is companies are not performing for quite a long
20 time at the time that they decide to do a repricing.
21 Companies don't reprice all the time. They wait until
22 the company has experienced a long downturn in the
23 business before they take that step to reprice options.

24 So you can have situations where companies are
25 repricing options that are granted over three, four or

1 five years, and treating those grants as if they're all
2 granted -- re-granted on one date, the repricing date,
3 can cause the limit to be exceeded just as a result of
4 the repricing.

5 MR. MILLER: And it poses an interesting
6 decision for management. Thankfully, I haven't needed to
7 go through a repricing yet, but the notion of doing a
8 repricing is something that you want to do for the
9 benefit of employees. For whatever reason, business
10 operations haven't gone as planned, your stock isn't as
11 valuable as it was before, and employees end up with
12 underwater options, and so you want to do the right thing
13 by your employees. And one of the things that you would
14 do in a situation like that is repricing stock options,
15 and the way that the legislation works today, there's
16 actually a negative incentive to do that because
17 potentially by doing that, you would trip this threshold
18 and then be forced to go through what would for all
19 intents and purposes be like public company financial
20 reporting.

21 So this is an area that I certainly haven't
22 dealt with specifically from the context of having to go
23 through a repricing, but I think the intent of the
24 discussions that we're having is making sure that this
25 type of legislation promotes doing the right thing for

1 employees, and I think this is a very specific example of
2 where me, in my role as CFO, there would be an incentive
3 not to necessarily do the right thing by employees
4 according to the letter of the law.

5 So I think it's important to just highlight
6 that there is that disconnect as it stands today.

7 MS. MCCARTHY: And we have seen companies who
8 are facing this issue choose to reprice only options held
9 by executives to minimize the impact on the limit, the
10 hard-cap limit and the soft-cap limit. We have also seen
11 them choose to reprice only executive options because
12 they choose to use an accredited investor exemption
13 rather than Rule 701. And this goes to Steve's point
14 that they only are choosing to do that because they can't
15 do a broader repricing without exceeding the hard-cap
16 limit under Rule 701.

17 We would propose that in addition to making
18 clear that a repricing is not a new grant or sale under
19 Rule 701, that the rule, the proposed rule, would cover
20 all material amendments to any securities previously
21 issued under Rule 701 so long as they don't result in a
22 new issuance of a security. So, for example, changes to
23 vesting provisions, other material changes to the terms
24 of the grant. Again, this is not addressed currently
25 under the rules, and it's not addressed in the C&DIs, but

1 we think any rule that would cover this topic should
2 cover any material amendments to any securities
3 previously issued under Rule 701.

4 The next item that we'd like to talk about is
5 clarifying the option -- the application of Rule 701 to
6 restricted stock units. Rule 701 currently has no rules
7 that specifically discuss and apply to restricted stock
8 units. At the time that Rule 701 was adopted, private
9 companies as a general matter were not granting
10 restricted stock units, but it has become a form of
11 equity compensation that many private companies have
12 started to use, and the fact that restricted stock units
13 are not specifically addressed in Rule 701 creates
14 ambiguity in a number of ways that we think would be
15 helpful to resolve.

16 So we recommend clarifying the rules as they
17 relate to RSUs. We recommend clarifying that RSUs are
18 considered sales on the date of grant, similar to stock
19 options. RSUs are derivative securities, just like stock
20 options, where no shares are issued unless and until the
21 RSUs vest and settle. We also recommend clarifying that
22 RSUs should be valued at the value of the shares
23 underlying the RSUs as of the date of grant.

24 The next item that we'd like to talk about is
25 the timing -- rationalizing the timing of the expanded

1 disclosure that's required to be provided. So, for
2 example, if you've crossed over the threshold on January
3 1st, you might be given three months to prepare the
4 disclosure and start providing the disclosure to sales
5 that occur after that time.

6 The next item we'd like to talk about is
7 clarifying the timing and delivery requirements of the
8 expanded disclosure. Rule 701 currently requires that
9 the expanded disclosure be provided a reasonable period
10 of time prior to sale, or for stock options or other
11 derivative securities' exercise or conversion. There's a
12 lot of confusion amongst practitioners in companies as to
13 what that means, what a reasonable period of time prior
14 to sale is. There's no guidance currently that provides
15 any help in determining what a reasonable period of time
16 prior to sale is.

17 We recommend revising the rule to provide that
18 any disclosure delivered at any time prior to the sale
19 such that the recipient has an opportunity to review the
20 disclosure will satisfy the obligation to deliver
21 disclosure.

22 We also recommend revising the rule to provide
23 that making the disclosure available in any manner
24 consistent with the SEC's electronic disclosure rules,
25 i.e. in an online data site, for example, satisfies the

1 disclosure obligation and the measurement period
2 applicable to the soft-cap limit. The way that the soft-
3 cap limit currently works is if an issuer exceeds \$5
4 million in securities issued pursuant to Rule 701 in any
5 12-month period, that issuer must provide expanded
6 disclosure to the recipients of those securities in that
7 12-month period.

8 The problem is you may not discover that you
9 exceed the limit, the \$5 million limit, until the end of
10 the 12-month period. However, you may have sales that
11 occur at the beginning of the 12-month period that are
12 technically required to receive the disclosure. This
13 sets up a very difficult situation for companies because
14 companies are effectively forced to guess or predict
15 whether they'll exceed the \$5 million limit in any 12-
16 month period in order to ensure that they're providing
17 the required disclosure so that they don't have a
18 violation of the limit.

19 We recommend changing the rule to provide that
20 the expanded disclosure is not required until after the
21 threshold is exceeded. The current rule is impractical
22 in application and has no clear rationale.

23 Consideration should also be given to whether
24 there might be a buffer period after the threshold is
25 passed to give companies the time to pull together the

1 obligation to deliver disclosure and that there's no
2 requirement to confirm actual receipt or review of the
3 disclosure. This is an item that actually has come up
4 from time to time with my clients, where there is concern
5 that even if the disclosure is made available and
6 properly delivered, that they're not able to confirm that
7 the email has actually been opened or the data site has
8 actually been accessed and the disclosure has been
9 reviewed, and there are some questions about what level
10 of certainty is required in order to confirm that
11 delivery is complete, and it would be helpful to clarify
12 that.

13 Finally, we recommend revising the rule to
14 provide that making the disclosure available in a
15 physical location that can be accessed by the individual
16 satisfies the obligation to provide disclosure.

17 The next item we'd like to talk about is
18 conforming the timing of the disclosure obligation for
19 options and restricted stock units. As I mentioned just
20 a few minutes ago, Rule 701 provides that disclosure must
21 be provided to option holders a reasonable period of time
22 prior to exercise. C&DI 271.24 requires the disclosure
23 to be provided to RSU holders a reasonable period of time
24 prior to grant. In adopting the C&DI, the SEC
25 distinguished between stock options and other derivative

1 securities that are exercised or converted and restricted
2 stock units, which they acknowledged are derivative
3 securities but they indicated are not exercised or
4 converted.

5 We recommend adopting a rule that conforms the
6 rule for options and RSUs. RSUs are derivative
7 securities; they are settled rather than exercised or
8 converted, but we think that's a technical difference
9 that shouldn't make -- a technical distinction that
10 shouldn't make a difference. And we recommend, again,
11 conforming those rules.

12 The next item we'd like to talk about is
13 decoupling expanded disclosure from Reg A and simplifying
14 the required disclosure. What we're talking about here
15 is the financial disclosure that's required pursuant to
16 the expanded disclosure requirement. The expanded
17 disclosure, the financial disclosure that's required is
18 the financial disclosure that's required under Reg A.

19 Reg A was recently revised, creating a
20 significant amount of complexity and confusion with
21 regard to its application to Rule 701. Some of this
22 complexity was addressed in a recent C&DI which allows
23 issuers to choose to follow the requirements of Tier 1 or
24 Tier 2 of Reg A. However, a substantial amount of
25 complexity continues to exist in terms of how Reg A is

1 applied in the context of Rule 701.

2 We recommend simplifying the disclosure
3 required under the expanded disclosure requirement by
4 decoupling it from Reg A, and instead requiring a current
5 balance sheet and income statement. In the legislative
6 history to the 1999 release, the SEC stated they thought
7 the Reg A disclosure was a type of disclosure that many
8 private companies would be familiar with, suggesting that
9 the financial disclosure required under Reg A would not
10 be unduly burdensome or difficult to comply with. In
11 practice and what we see with companies is this is not
12 generally true. The level of disclosure required under
13 Reg A for companies that are first subject to the
14 disclosure rules is substantially more burdensome than
15 what most private companies are used to having to
16 provide, and companies often incur significant expense
17 and spend a significant amount of time putting together
18 that disclosure.

19 Although audited financials are technically not
20 required under the rules, many companies also feel that
21 they need to provide disclosure that's effectively
22 equivalent to audited financials in order to ensure that
23 the financial disclosure complies with the rules, which
24 requires compliance with GAAP. They also have questions
25 about whether footnote disclosure is required where it

1 might be required under GAAP, and there's just a lot of
2 ambiguity in terms of what companies can do and what it
3 means to provide GAAP-compliant financial disclosure
4 that's not audited.

5 MR. MILLER: Sure. So one of the benefits of
6 being a privately held company is that you can maintain a
7 higher level of confidentiality over your financials, for
8 a number of different reasons. I think one of the
9 positive aspects of Rule 701 is that it encouraged
10 transparency, and I think in general it's good to operate
11 in a transparent way, whether you're a privately held
12 company or whether you're a public company.

13 But while you are a private company, it takes
14 quite a bit of time to put in place the people,
15 processes, systems, infrastructure to operate as a public
16 company would, and in particular it takes a fair amount
17 of time and effort to put together GAAP-compliant
18 financial statements and to go through the audits that
19 you would want to go through from your accounting firm so
20 that you can put financials in front of employees in a
21 way that you feel are accurate and are not going to
22 change. Particularly if you are a private company that
23 is potentially going to become a public company, you
24 don't want to be in an odd position of having put out
25 financials which say one thing and then when you're

1 filing your S-1 they say something completely different.

2 So I think it's a very important topic just to
3 think about in the context of how you want to spend your
4 time as a startup company executive. Is it putting
5 together financial statements, which we do -- we do now
6 better than we did before; putting together risks and
7 various disclosure statements; or is it actually
8 operating the day-to-day of your business?

9 So I think there is certainly a fine, fine line
10 between transparency and between creating an undue burden
11 on companies. I'm a big proponent of transparency and we
12 do what we can, and we tend to go above and beyond what
13 most private companies do to report on their financial
14 performance to their employees. But at the same time,
15 it's important to bear in mind putting in place anything
16 that would be too onerous for a private company to comply
17 with to create and put forward financial statements for
18 this particular exercise.

1 1007.mp3

2 MS. MCCARTHY: The next item we wanted to talk
3 about was changing the frequency in which the financial
4 disclosure must be updated. As I noted at the beginning
5 of the talk, the financial disclosure must be dated as of
6 a date that's within 180 days of the sale. We think that
7 when this rule was first adopted, the expectation was
8 that that would mean that the financials would need to be
9 updated every six months. However, as a practical
10 matter, it takes time to prepare the financials and put
11 them in a form where they're ready to be delivered, which
12 means that companies that are required to provide the
13 financial disclosure actually have to update and provide
14 the disclosure quarterly. So it's really a quarterly
15 obligation and not a semiannual obligation.

16 We recommend revising the rules to require the
17 financial disclosures be updated and provided once a year
18 unless a material event results in a material change in
19 the enterprise value of the company or the value of the
20 securities to be issued. The current rule with quarterly
21 reporting is unduly burdensome and costly for private
22 companies. It requires a tremendous amount of resources
23 for them to put together the financials each and every
24 time that they're put together, and quarterly seems to be
25 too much.

1 The proposed rule, as we've written it,
2 generally conforms to an IRS rule that private companies
3 look to when they are setting the value for pricing their
4 stock options. It's referred to as 49a, and it's very
5 similar in terms of how it's structured where you can
6 rely on a valuation for up to a year unless a material
7 event occurs that would require you to provide it more
8 frequently. And we think that that standard strikes a
9 good balance between ensuring that the disclosure is
10 adequate and the cost and burden of putting together the
11 disclosure.

12 The next item we'd like to talk about is
13 conforming the consequences of a violation of the
14 expanded disclosure requirement and the hard-cap limit
15 violation. A violation of the hard-cap limit results in
16 the loss of Rule 701 for any securities that are sold in
17 excess of the limit. A violation of the expanded
18 disclosure obligation, however, results in the loss of
19 the Rule 701 exemption for all securities that were sold
20 during the relevant 12-month period. We recommend
21 conforming the consequences of violating the expanded
22 disclosure obligation with the consequence of violating
23 the hard-cap limit such that only those sales pursuant to
24 which the expanded disclosure is not provided are the
25 sales that lose the Rule 701 exemption.

1 Oftentimes a failure to provide expanded
2 disclosure is an inadvertent result of an administrative
3 error. Sometimes it's a technical error where access is
4 not provided via an online data site. There's no clear
5 rationale for the punitive result that currently exists
6 where the Rule 701 exemption is lost for all sales that
7 occur in that 12-month period.

8 Under the proposed rules as we've conceived it,
9 if there is broad-based failure to provide disclosure,
10 then there would be a broad-based loss of the exemption.

11 Finally, and this may be now a moot point, we'd
12 like to propose that we increase the soft-cap limit from
13 five million to 10 million dollars. We understand that
14 legislation has been passed and is waiting for the
15 President's approval, so happy to go through it, but I
16 think we may be there. I'm happy to --

17 MR. MILLER: Fast results.

18 MS. MCCARTHY: -- take any questions, and
19 again, thank you very much for allowing us to talk today.

20 CO-CHAIR HANKS: Thank you.

21 MR. MILLER: Thank you.

22 CO-CHAIR HANKS: So, questions.

23 MS. MOTT: This is not a question, this is a
24 comment. I'm on the board of many startup companies,
25

1 several, and everything you recommend seems very
2 reasonable. My question might be for Steve maybe to talk
3 -- if I have a question here. Could you describe, you
4 know, as the company has scaled, how this has -- you
5 know, and you continue to do -- obviously, you're using
6 eShares now. But, you know, I can imagine the complexity
7 of this, and particularly when your valuations are
8 changing if you're taking on additional rounds. So can
9 you maybe highlight that a little bit for folks and just
10 give us a picture of what it's like in the world of Warby
11 Parker?

12 MR. MILLER: Sure, sure. And it's certainly
13 evolved over time, and we're in a much better place right
14 now to track and comply with Rule 701 in more of an
15 institutional way. But when I joined the company over
16 six years ago, there were maybe 30 to 35 employees at the
17 company. There was no finance department. I walked in
18 and had to figure out how to understand our financials
19 and hire a team and get involved in various other
20 initiatives across the company. So in the early days,
21 the thought of complying with Rule 701 wasn't even in the
22 cards for me, and it probably wasn't until a year or so
23 later that I became more aware of this particular topic,
24 just because I was much more focused on other areas, we
25 didn't have a general counsel, we didn't have an in-house

1 lawyer.

2 So fast-forward, you know, from six years ago

3 to today, we now have an accounting department of

4 approximately eight people and growing. We've got more

5 specialized functions and we're taken the time to

6 understand the topic and actually select a technology

7 tool from a company which is itself a startup, a company

8 called eShares, that has really helped us automate the

9 tracking of this particular topic in a much easier way.

10 So it's definitely been an evolution, and I

11 remember the first time that counsel pointed this out to

12 me. I was like a deer in the headlights. And then it

13 took some time to understand the nuances; it took some

14 time to build a team; it took some time to select a tool.

15 And we're in a much better spot right now.

16 I hope that addresses what you were getting at,

17 or --

18 MS. MOTT: Yeah, and I think about other issues

19 of scaling. I mean, you're trying to think about, you

20 know, there's -- you're juggling a lot of things. But I

21 think, has it ever impeded your ability to hire talent,

22 be able to offer something to attract the kind of talent

23 you need? You looked at this and said, oh gosh, we're

24 near our limit; we can't do it? I mean, have those kinds

25 of things existed for you as the company continues to

1 scale?

2 MR. MILLER: Yeah, it's made us think about

3 option grants with more forethought ahead of time, and

4 we've actually been in a situation where had we not taken

5 advantage of the accredited investor exemption, we would

6 have exceeded the \$5 million limit.

7 MS. MOTT: That's what I was looking for, yeah.

8 MR. MILLER: Yeah. Yeah, for sure. So it's

9 definitely made us approach this area with a lot more

10 caution, and when you're a startup company, you prize

11 flexibility, you want to be nimble, you want to make

12 quick decisions, and this is certainly an area which has

13 added additional headwinds into the process.

14 MS. MOTT: And the cost of valuations, right?

15 When you -- I mean, do you do 409A or what are --

16 MR. MILLER: We do, we do.

17 MS. MOTT: Yeah.

18 MR. MILLER: So every company has to deal with

19 the 409A valuation process. And again, I understand the

20 intention of the process, but there's oftentimes a large

21 difference between the 409A and the real-world value, but

22 we all rely on the 409A value and we have to update that

23 value certainly at least once a year; when you're a more

24 mature company particularly with an eye to going public,

25 you want to do that at least once a quarter if not more

1 often, and you want to change from one methodology to

2 another methodology.

3 So it becomes quite complicated. It's a

4 process that we go through now on a quarterly basis, and

5 it's quite costly because we involve a number of parties.

6 There's our third party stock option valuation firm,

7 which does our 409A values. We run all of our valuations

8 past our accounting firm. We work with Ernst & Young.

9 And there's typically a back-and-forth set of conference

10 calls between the two, so we're ringing up fees in the

11 process.

12 And then it requires my controller to put

13 together historical financial statements amongst a number

14 of other items on a due diligence request list. We then

15 include in analysts from my financial planning and

16 analytics team to put together updated -- an updated set

17 of projections. And then we finally arrive at the value,

18 which we would then use as an input to understanding

19 whether or not we would bump up against the \$5 million

20 limit.

21 So it -- as I'm talking through this, you're

22 reminding me how many parties are actually involved, how

23 complicated the process is, how much time it takes, and

24 how much money we actually spend on this.

25 MS. MOTT: So I see how easily this -- you

1 could inadvertently bump up against things, particularly

2 when you're a startup with limited resources and not

3 having the ability to pay for some of these things,

4 right? Especially when you're trying to scale and

5 compete. So I appreciate both what you're -- what you've

6 done today and what you said today, and I think it's

7 clarified, you know, many things here.

8 MS. MCCARTHY: We do in practice come across

9 companies who have exceeded the limit, either the hard-

10 cap or the soft-cap limit, without realizing that they've

11 done so. We take them over as clients and maybe they

12 didn't have the resources in place to really properly

13 track the limits. And that often then requires them to

14 go through a very expensive process of trying to figure

15 out, can we remove grants that were made -- that we

16 thought were made pursuant to 701 that we need to rely on

17 accredited investor exemptions for? Can we remove all of

18 the grants that have, you know, been canceled? And it's

19 a very, very expensive process.

20 CO-CHAIR GRAHAM: We don't -- sorry, we don't

21 take questions from the audience. Want to join us?

22 AUDIENCE MEMBER: (Inaudible.)

23 (Laughter.)

24 MR. YADLEY: While you're clarifying that, you

25 mentioned revising the rule to be able to provide

1 documents in a physical location. I assume that's for
2 confidentiality. What would you like to do that should
3 be addressed in the rule?

4 MS. MCCARTHY: Yeah. So we'd actually like the
5 rule to state just that, that so long as the individual
6 has the ability and the means to access the physical
7 location, that providing the disclosure physically will
8 satisfy the rule of delivering the disclosure. There's
9 some concern that doing it in that way won't satisfy the
10 delivery requirement because the SEC may view that as not
11 sufficient or adequate for the individual to actually sit
12 down and review the disclosure, that they may need to
13 physically receive it to be considered to have delivered
14 the disclosure to them.

15 MR. YADLEY: Right. So if, for example, an
16 employee wanted to (inaudible) advisor or accountant --

17 MS. DAVIS: Could you talk a little closer to
18 the mic? Thanks.

19 MR. YADLEY: Sorry, to have -- if the employee
20 wanted a financial advisor, attorney or accountant to
21 look at it, they may not be able to do that.

22 MS. MCCARTHY: Yeah, as a general matter,
23 that's not permitted even when the disclosure is
24 delivered electronically. The disclosure is generally
25 delivered in a way that requires the individual receiving

1 having people enter into confidentiality agreements, and
2 I think as a general matter people feel -- people do
3 certainly do that, but feel that it doesn't provide any
4 real protection because then you have a breach of
5 contract while your financial information is out and
6 about. So the harm is just very -- potentially very
7 severe.

8 MS. TIERNEY: So you know we work with a lot of
9 private companies and we're big supporters of updating
10 these rules and making the types of changes that you're
11 suggesting. You know, another way to look at it is not
12 just the burden to the company of the financials --

13 MS. DAVIS: The mic.

14 MS. TIERNEY: Sorry. We're all talking too
15 low, Julie. Sorry. I've got high energy, Patrick. I
16 just got a scratchy voice today.

17 One of the things that I think is -- the look-
18 back never made sense to me. Right, the idea that you
19 have to go back 12 months and you should be providing
20 disclosure for 12 months. I never understood, like, the
21 policy behind that, but it really hurts high-growth
22 companies, right? So if you're having a great year and
23 you have your 409A valuation done, that's when you found
24 out that you've exceeded the five million number. And
25 like, it just doesn't make any sense to me that the

1 the disclosure to maintain the confidentiality of the
2 disclosure and not just share it with any parties.
3 Sometimes there are exceptions to that, but most
4 companies have a very strict rule on that, that it's
5 really the disclosure goes only to the individual and not
6 beyond the individual.

7 The concern, as you noted, is confidentiality.
8 There's a tremendous amount of sensitivity to
9 confidentiality amongst private companies who are not
10 otherwise subject to public review and do not have their
11 financial information publicly disclosed. There's real
12 concern that having their financial information publicly
13 disclosed will lead to competitive disadvantage for them,
14 and so there's a lot of angst over this particular issue.

15 Delivering the disclosure via electronic sites
16 and other methodologies sometimes is viewed as
17 insufficient by some companies because they feel that
18 people can, you know, take screenshots; there's other
19 ways in which you can capture the information. It's
20 very, very difficult to predict -- protect. Some
21 companies will watermark the screen so that if you take a
22 screenshot, it could be discovered later, you know, who
23 was distributing the disclosure. But nothing is really
24 fully sufficient to protect the information.

25 In the legislative history, the SEC mentioned

1 current rules actually put companies as a disadvantage
2 for being successful, so I really support what you're
3 recommending.

4 MS. MCCARTHY: The idea of having to predict
5 whether or not you'll exceed the limit is an idea that
6 most of my clients look at me and think I'm crazy, that I
7 must be misinterpreting the rule, because it really -- it
8 really doesn't make a lot of sense and there is no real
9 clear policy objective for that. And we have -- I have
10 had a number of clients that have started providing
11 disclosure during periods when they haven't exceeded the
12 threshold because they are worried about having a
13 violation; they're worried that their price will go up
14 significantly and that they will exceed the limit, and
15 the only thing that they can do in that circumstance is
16 to start providing the disclosure.

17 MS. TIERNEY: I've got one more question. I
18 think the way that lawyers interpret the rules, and I
19 might be incorrect, is that once you start providing the
20 disclosure, you continue to do so regardless of whether
21 or not in the next 12-month period you go below five
22 million. Is that right?

23 MS. MCCARTHY: I think, technically, everyone
24 understands that you look at each 12-month period as a
25 discrete 12-month period, and theoretically, if the value

1 went down during any period, you wouldn't be required to
2 provide the disclosure to the grants and sales that were
3 made during that period.

4 I think most advisers counsel their clients to
5 provide the disclosure and to continue to provide the
6 disclosure going forward to everyone, regardless of
7 whether you go below the \$5 million threshold. And the
8 reason is it's too hard to pick and choose who you're
9 sending the disclosure to and it's too easy to make a
10 mistake, and it's -- the penalty is too extreme because
11 you lose the -- you lose the Rule 701 exemption for
12 everyone in the 12-month period.

13 So, in fact, in addition to the situation that
14 you just described, most companies will start providing
15 disclosure to everyone who's holding an outstanding
16 option at the company regardless of when it was received,
17 once the company starts providing the disclosure, and
18 that's a big part of the reason.

19 CO-CHAIR HANKS: And disparate information is
20 always going to be a problem anyway.

21 MS. MCCARTHY: Yeah.

22 CO-CHAIR HANKS: Just sort of to look at the
23 soft cap, is there a point to the soft cap at all, in
24 your opinion?

25 MS. MCCARTHY: To provide -- look, the soft cap

1 triggers the financial disclosure, which I think is the
2 primary purpose of --

3 CO-CHAIR HANKS: Yeah, but is -- is there a
4 point to actually providing that? I mean, if it's okay
5 under the amount and investor protection is served under,
6 then you get into the arbitrary -- I mean, like, there's
7 a huge element of arbitrariness. Does it actually add to
8 investor protection in the type of companies that you're
9 working with?

10 MS. MCCARTHY: I would say it probably doesn't
11 because it's often the case that people receive grants
12 very early on at the company, option grants, and they
13 don't exercise those grants until the company goes public
14 or after the company goes public. And in that case, you
15 know, the exercise price may be low, so the actual
16 investment cost, the exercise price cost may be low, but
17 the total cost of the transaction can be very, very high
18 when you factor in the tax costs.

19 So what I would -- my understanding of the
20 purpose of the rule is to protect investors, and where --
21 the idea is where the cost and the investment is
22 significant enough that at that point it becomes
23 important to protect the investor and provide them with
24 some disclosure.

25 But as I just explained, there's no reason why

1 the earliest investor shouldn't be protected just like
2 the latest investor, and therefore, what's the
3 difference?

4 MR. YADLEY: But isn't -- I mean, and that's
5 sort of the point here. If these are compensatory
6 transactions and you're getting this as part of your
7 compensation, and you're happy to get them, and they're
8 options (inaudible) documents, things that are going to
9 have future value, you hope. Why do you need disclosure
10 at all here? When it's time to make an investment
11 decision such as exercising it, I agree you should
12 (inaudible). I am certainly in favor of dealing with the
13 soft cap.

14 MS. MCCARTHY: I think there would be a good
15 justification for doing away with the soft cap and the
16 disclosure requirement altogether for RSUs, which
17 actually requires no action on the part of the recipient.

18 They receive the grant; at the time of receipt it's a
19 non-event, it's a contractual right to shares in the
20 future after the shares vested are settled. At that
21 time, they receive the value -- they receive the shares,
22 which is a taxable event, but there is no action that
23 they take in order to receive that value.

24 MR. YADLEY: Right, I haven't worked with any
25 startup companies that say, "Here's your options, but if

1 you don't want them we'll give you cash instead."

2 (Laughter.)

3 MS. MOTT: Doesn't work that way. So, Gregory,
4 you brought up something I think that's really important
5 in the scheme of this, is that if they're worth anything
6 later, right, because how many of these companies don't,
7 you know, get to the point of Warby Parker or, you know,
8 or to an exit. So since it's something -- a contractual
9 right for something in the future, it's only relevant in
10 the future if it turns into something, and the same thing
11 with valuations. It's so gray. It's such a gray area in
12 this asset class. So, glad you brought that up.

13 MS. MCCARTHY: And for RSUs, since there's no
14 action taken in order to settle the RSUs, it's
15 inconceivable in my mind that someone would turn their
16 back on the RSUs as a result of receiving disclosure and
17 say, "No thank you, I'm not interested in receiving these
18 shares because they are worth less than I thought they
19 should be."

20 MS. TIERNEY: I would also say that being a
21 former employee of a private company, you make your
22 investment decision when you take the job, right? You've
23 -- you're agreeing to take equity as a big part of your
24 compensation going in the door, so I think you're making
25 that investment decision as part of your career. And I'm

1 not given financial statements when I take the job,
 2 right, so I don't get what it gets me later on.
 3 MS. MCCARTHY: And the assessment that
 4 candidates do in that process, too, is a much more
 5 generalized assessment than, you know, a review of
 6 financial statements. It's an assessment of the overall,
 7 you know, strength and opportunity at that business and
 8 where we think that business will head and what we think
 9 it will do, and do we think this is a good investment of
 10 my time and energy, you know, working for this business.
 11 Do I think it's going to grow and develop and be the
 12 next great thing?

13 MR. GOMEZ: Can I play devil's advocate there
 14 for a minute and just -- if -- and going to Annemarie's
 15 point, if I'm trying to make a decision as to whether
 16 this company is a company where I want to work, and by
 17 that also take part of my compensation in the form of
 18 equity rather than cash, doesn't that actually go to the
 19 point of wouldn't I want to know more about the company
 20 at the time that I am actually starting with the company
 21 to decide whether the \$100,000 plus \$50,000 worth RSU is
 22 comparable to that other offer that I got from another
 23 company that was \$150,000 in cash and only \$25,000 in
 24 RSUs?

25 MR. VERRET: Can I just respond to that?

1 on a set of projections that are, you know, unproven, and
 2 they will continue to be unproven while the company
 3 scales. You know, what we all hope to be is that by the
 4 time it gets to be in its fifth year, it's at 50 million
 5 or 100 million or 500 million, whatever it is. You know,
 6 by then -- you know, and again, if it's a biotech company
 7 there's really -- it still continues to be really gray.

8 So, you know, I guess what I'm saying is that I
 9 hear what you're saying, Sebastian, but boy, as an
 10 employee, when I think about people who jump into
 11 Facebook or jumped into, you know, these startup
 12 companies, they were just like -- it's like this.

13 MS. MCCARTHY: Yeah.

14 MS. MOTT: You know? I mean, they're hoping
 15 it's going to be something big, but how big is it going
 16 to be and what does it mean to my bottom line, to my
 17 retirement plan, to anything like that. I'm clueless.
 18 I'm jumping on hoping that this -- I'm going to really
 19 work hard and try to make this worth something. And I'm
 20 sorry it's just like -- it's not -- it's not black and
 21 white in this world. It's really gray. I think --

22 CO-CHAIR HANKS: It's not usually even written
 23 down. I mean, speaking as a startup, I mean, our
 24 financial statements for the first three years were zero,
 25 zero, zero, zero, zero, zero.

1 Mandatory disclosure is not the only way for you to get
 2 what you require. You should negotiate for, as an
 3 employee, negotiate to receive those financial statements
 4 and say, "I've got another offer. I think I'm going
 5 there but maybe you can" -- I mean, you know, mandatory
 6 disclosure is not the only way to get access to
 7 information. I mean, that's an ongoing issue.

8 MS. TIERNEY: Right, but you're not getting
 9 access to financial statements when you're negotiating to
 10 start at a private company. I mean, that's not generally
 11 part of the onboarding process. It certainly wasn't at
 12 the company where I worked. Do you see that where you
 13 are?

14 MS. MOTT: So one of the things I -- so I'm
 15 thinking, okay, let's start with this -- the very
 16 beginnings of the company. You know, one of the things
 17 is we don't have a history of accounting records or
 18 anything. I mean, what you have are projections and
 19 they're based on a set of assumptions that are unproven.
 20 So when you're putting value out there, and particularly
 21 even still through, you know, maybe the second or third
 22 stage, it's hard to say what they're going to be worth,
 23 you know, I mean, to price things.

24 It's difficult enough when -- I will vouch for
 25 this as an investor -- to put a value on a company based

1 (Laughter.)

2 CO-CHAIR HANKS: And then they were -- you
 3 know, we had some projections which were absolutely
 4 unrelated to reality in any respect and depended on
 5 certain people drafting rules at a specific time. But,
 6 yeah, it's -- I mean, people who joined us joined because
 7 they were like, "Yeah, this is a good idea -- like the
 8 team."

9 MS. YAMANAKA: If you have the financials,
 10 you'll take them, right? With a grain of salt of
 11 whatever they are. But I think when you're -- when
 12 you're willing to take that equity compensation, you're
 13 really looking more like the biotech. Like you said,
 14 it's like, "Can you pay my paycheck that you committed
 15 to, you know, next month? And what's your burn rate?"
 16 You know, and that's more relevant than, frankly,
 17 financial information at that particular time. And do
 18 you have faith in the product that they're going to be
 19 able to do something great? Not as great as the
 20 projections, because projections are always like
 21 whatever, but do I have faith in the people and can they
 22 support me from a cash perspective in an area that I'm
 23 comfortable with? Some people are comfortable, hey, one
 24 month and we're fine; other people, six-month reserves,
 25 nine-month reserves, whatever.

1 So it -- you look -- people who are willing to
2 take this -- and I'll say I've been guilty of it too.
3 You know, I'm an accountant and some things have just
4 gone out the door because, yeah, these financials look
5 really terrible but I really have faith in the
6 organization and I'm willing to take a risk, and I can
7 afford to take a risk.

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11 MR. MILLER: Expressing the value of stock
12 options to employees is very much an imprecise science
13 because literally, if you want to be honest with the
14 person, and I think you always want to be honest, it's
15 that these options could be worth nothing or they could
16 be worth a fortune or somewhere in between. And it
17 sounds like almost a very evasive answer, but it's really
18 the truth. That obviously changes over time, so a
19 company that's doing zero in revenue is very different
20 from a company that's doing 100 million in revenue which
21 is different from a company that's doing a half a billion
22 in revenue and is profitable.

23 But particularly at the earlier stages of a
24 startup's -- of a startup company's existence, you can
25 talk about vision and you can talk about the future and

1 you can provide some parameters that would allow a person
2 to do the basic math to value stock options. But the
3 honest truth, particularly at the earlier stages, which I
4 think is really what we're focusing on here, it's very,
5 very much an imprecise science, and the people who tend
6 to get attracted to startup companies have a few traits
7 in mind. One just might be to need a job. Two, believe
8 in the vision and are mission-driven individuals. Three,
9 are risk-takers. Four, want to create something that's
10 never been created before. And it's really those more
11 emotive aspects of taking a job that would draw someone
12 to a startup, and it's the option compensation which
13 sexing -- that's secondary, is a strong word, because we
14 do live in a capitalist society and we can point to tons
15 of examples where people have made fortunes off of their
16 stock options, but trying to put that into a scientific
17 equation, particularly at the earlier stages, becomes
18 very, very unrealistic.

19 MR. REARDON: I am a little -- well, I think my
20 knowledge is out of date. If -- under 701, if I make the
21 mandatory disclosure when I give stock options in another
22 employee compensation, does that absolve me from making
23 disclosure when those options are exercised?

24 MS. MCCARTHY: So the timing of the disclosure
25 requirement for stock options is a reasonable period of

1 time prior to exercise.

2 MR. REARDON: Okay. So what's the purpose?
3 Well, let's put the law under 701 aside for a second and
4 just look at the general securities laws. If I give
5 Catherine an option and she's an employee, I thought the
6 rule was -- and the option is not in the money; it's
7 either fair market value or at some higher value -- that
8 that's not a securities transaction at that time. Is
9 that correct?

10 MS. MCCARTHY: I think that there's a C&DI that
11 actually says it's considered a securities transaction
12 but it's not -- there's no requirement for an exemption
13 or a registration at the grant of an option.

14 MR. REARDON: There's no purchase and sale --
15 purchase or sale.

16 MR. GOMEZ: The requirement for disclosure
17 under 701 for an option --

18 MR. REARDON: We're forgetting about 701.
19 Forget it. Just it doesn't exist. Okay, outside of 701.

20 MR. GOMEZ: So, Patrick, I can't live on a --
21 in a world where there is no 701 when we're talking about
22 701.

23 (Laughter.)

24 MR. GOMEZ: But I think the point that I wanted
25 to make is that with respect to options, there is no

1 requirement to provide disclosure at the time of the
2 grant of the option. The requirement to provide the
3 disclosure, it's a reasonable time prior to the exercise.

4 MR. REARDON: Okay.

5 MR. GOMEZ: Which is different than what would
6 happen with respect to a grant of common stock, preferred
7 stock, or RSUs.

8 MR. REARDON: Okay, what about a restricted --
9 what is a restricted stock unit? Is that the same thing
10 as a phantom stock right?

11 MS. MCCARTHY: It's similar. A restricted
12 stock unit is a contractual right to receive shares in
13 the future. So at grant, it's a piece of paper that says
14 you're entitled to a certain number of shares at a
15 certain time in the future, when -- typically when you
16 meet vesting conditions and when the vesting conditions
17 are satisfied, then the shares settle and you receive the
18 shares.

19 MR. REARDON: But you don't pay any money.

20 MS. MCCARTHY: There is no purchase price paid
21 at any time.

22 MR. REARDON: Again, is that a securities
23 transaction?

24 MS. MCCARTHY: There is an ongoing debate about
25 whether an RSU involves a sale, for securities purposes.

1 I think as a general matter, the SEC's view is that it
 2 is a sale transaction at the time of grant of an RSU.
 3 MR. GOMEZ: There is a line of no-action
 4 letters that considers that there's instances where the
 5 grant of an RSU would not be a sale, and we call them --
 6 I call them the no-sale-theory line of no-action letters.
 7 So when the staff issued that CDI, the staff noted in
 8 the CDI as well that companies may want to consider
 9 whether the no-sale theory applies to a specific grant of
 10 RSUs. Say, for example, every new employee that comes to
 11 the company automatically will get a grant of 500 RSUs
 12 and there's no negotiation, there's nothing else. So the
 13 staff in the CDI did point out to that as a way for
 14 companies to think as to whether they did, in fact, have
 15 something that triggered the company having to look at
 16 701 or not.
 17 MR. REARDON: Interesting. Do you make an
 18 83(b) election on an RSI -- RSU?
 19 MS. MCCARTHY: There's no opportunity to do an
 20 83(b) election with an RSU because you receive the shares
 21 at the time of vest. So Section 83 and 83(b) elections
 22 are available for property that you receive that's
 23 subject to a risk of forfeiture. The time that you
 24 receive the shares pursuant to the RSU, it's not subject
 25 to a risk of forfeiture.

1 MR. REARDON: If -- what if you're fired?
 2 MS. MCCARTHY: The piece of paper that you
 3 receive at the time of grant of the RSU is not property
 4 for purposes of Section 83 and the tax rules.
 5 MR. REARDON: That's confusing.
 6 (Laughter.)
 7 MR. REARDON: Thank you.
 8 CO-CHAIR HANKS: All right. Before we go into
 9 any more tax, I think it's time to move along, I think.
 10 And I don't know if we want to talk about possible
 11 recommendations.
 12 CO-CHAIR GRAHAM: Well, first of all, thank
 13 you, Steve, and thank you, Christine. I thought that was
 14 -- that was very helpful (inaudible). It wasn't as much
 15 as the discussion, as we sat here and we learned from
 16 you. So I appreciate that.
 17 MR. MILLER: Thank you for having us.
 18 MS. MCCARTHY: Thanks again.
 19 CO-CHAIR GRAHAM: Yeah. So you are free to go
 20 if you would like, or you can sit here and kind of keep
 21 observing us if that's what you would like to do.
 22 MS. MCCARTHY: Great. Thank you very much.
 23 CO-CHAIR GRAHAM: All right. Thank you.
 24 Now, we weren't planning on making any more
 25 recommendations because we are -- we are nearly dead.

1 (Laughter.)
 2 CO-CHAIR HANKS: We've got 15 minutes.
 3 CO-CHAIR GRAHAM: But I think -- but I'm
 4 thinking a useful recommendation can easily be formed.
 5 And can I toss it to you, Annemarie, for in terms of just
 6 kind of stating a consensus?
 7 MS. TIERNEY: Sure.
 8 CO-CHAIR GRAHAM: I think that we should look -
 9 - okay, so this is my view, and we can -- and people can
 10 react to it. It seems to me that we've got some good
 11 ideas. It seems to me like generally speaking, we think
 12 that it would make sense to modernize 701 for the reasons
 13 that have been stated, and I don't think we need to spend
 14 a lot of time with a lot of detail in coming up with
 15 something that we'd view as a useful recommendation to
 16 the SEC. Does that make sense to people?
 17 CO-CHAIR HANKS: Yes.
 18 CO-CHAIR GRAHAM: So do you want to kind of
 19 give us some lead on that, Annemarie?
 20 MS. TIERNEY: Can I just pass a resolution with
 21 what she said, or do we have to do it?
 22 (Laughter.)
 23 CO-CHAIR GRAHAM: I'll yell and (inaudible).
 24 CO-CHAIR HANKS: (Inaudible.)
 25 MS. TIERNEY: So, I mean, I think if I was

1 going to make a recommendation, it would be to --
 2 CO-CHAIR GRAHAM: Because I know you've given
 3 this a lot of thought already.
 4 MS. TIERNEY: Yeah.
 5 CO-CHAIR GRAHAM: Probably more thought than
 6 any of the rest of us.
 7 MS. TIERNEY: With a lot of smarter people than
 8 I am. So I'll just sort of parrot what I've learned,
 9 which is a longer distillation of what we learned today.
 10 I really do think the SEC is open to looking at this
 11 space, which has been really good to know. We know that
 12 the number, the soft-cap number is about to change to 10
 13 million if the President signs it. But I really do think
 14 that the recommendation should be for the staff to take a
 15 look at 701 in the context of the testimony given today,
 16 particularly around RSUs. In my mind, the 12-month
 17 lookback that we don't seem to be able to find a policy
 18 argument for, although I'm sure there is one. I just
 19 don't know what it is. And the other items that Steve
 20 and Christine recommended in the slide deck. I think
 21 it's well worth the staff's time. I think, Sebastian,
 22 you mentioned that the legislation that may pass with the
 23 President's signature also directs the SEC to look at the
 24 701 space, so this is a good opportunity for you to do
 25 so.

1 MR. GOMEZ: The -- no, it doesn't.
 2 MS. TIERNEY: No?
 3 MR. GOMEZ: But it does require the SEC to do
 4 rulemaking to implement --
 5 MS. TIERNEY: Sorry, rulemaking.
 6 MS. TIERNEY: -- the change between five
 7 million to 10 million.
 8 MS. TIERNEY: So maybe it's a good time for the
 9 SEC to look at it as a broader category. We know that
 10 companies are staying private longer. We know that the
 11 five million number is tripping companies up, not through
 12 any sort of, you know, nefarious, you know, intent but
 13 just as actually an implication of hiring people, which
 14 we all support, and growth, which we all support.
 15 So my recommendation would be to look at 701 in
 16 the context of Christine's recommendations, especially
 17 around the 12-month lookback, the RSU wrinkle, and --
 18 CO-CHAIR HANKS: Natural person.
 19 MS. TIERNEY: -- natural person, and proposed
 20 rules, proposed rulemaking.
 21 CO-CHAIR GRAHAM: Okay, so it sounds like -- I
 22 mean, they just -- really, it was a great presentation.
 23 So it sounds like we can't -- I mean, I don't recall
 24 anything that was being recommended that I would take
 25 issue with.

1 CO-CHAIR HANKS: Yeah.
 2 CO-CHAIR GRAHAM: So I think that's where we
 3 are. Can -- give us a second. More discussion? All
 4 those in favor.
 5 (Chorus of ayes.)
 6 CO-CHAIR GRAHAM: Opposed.
 7 (No response.)
 8 CO-CHAIR GRAHAM: All right. You can still
 9 stick around if you want. We're almost done. As --
 10 MR. YADLEY: So J.W. got to contribute to the
 11 committee, and I think that's just great.
 12 CO-CHAIR HANKS: There you go.
 13 (Applause.)
 14 CO-CHAIR GRAHAM: Yeah. You did not earn that,
 15 by the way.
 16 (Laughter.)
 17 CO-CHAIR GRAHAM: As you know, this is -- this
 18 is our last meeting, and I just wanted to say it's been a
 19 pleasure serving with all of you. It's been an honor to
 20 have occupied this position for the last six years. And
 21 I want to thank again the staff, especially you two. I
 22 think the staff has been great over this time in terms of
 23 (inaudible) support. And that's all I got. Goodbye,
 24 good luck, and safe travels.
 25 CO-CHAIR HANKS: Thanks, everyone.

1 MS. MCCARTHY: Thank you.
 2 CO-CHAIR GRAHAM: Adjourned.
 3 (Whereupon, at 3:17 p.m., the meeting was
 4 adjourned.)
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1 PROOFREADER'S CERTIFICATE
 2
 3 In the Matter of: SMALL & EMERGING COMPANIES ADVISORY
 4 COMMITTEE MEETING
 5 File number: OS-0913
 6 Date: Wednesday, September 13, 2017
 7 Location: Washington, D.C.
 8
 9 This is to certify that I, Christine Boyce, (the
 10 undersigned) do hereby swear and affirm that the attached
 11 proceedings before the U.S. Securities and Exchange
 12 Commission were held according to the record, and that
 13 this is the original, complete, true and accurate
 14 transcript, which has been compared with the reporting or
 15 recording accomplished at the hearing.
 16
 17
 18 _____
 19 (Proofreader's Name) (Date)
 20
 21
 22
 23
 24
 25

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a.m 1:10 4:3,7 4:14 88:12	18:25 27:8	65:2,18,24	98:6 99:21,22	agreements 124:1
Abero 3:6 6:5 7:11 11:20 15:19 31:11	accountant 32:16,19,21 122:16,20 134:3	67:12 79:8,15 80:22 127:7	100:4 106:8 114:7	Aguilar 2:6
ability 6:20 7:23 22:8 50:1 52:3 56:13 57:2 64:2,15 81:24 82:22 118:21 121:3 122:6	accounting 17:23 30:15 31:8 40:25 43:4,4 60:18 61:3 112:19 118:3 120:8 131:17	added 71:23 75:21 76:4 77:4 102:18 119:13	adopting 101:9 102:23 103:5 109:24 110:5	ahead 11:9 46:5 62:8 119:3
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