



UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

THE CHAIRMAN

April 6, 2011

The Honorable Darrell E. Issa  
Chairman  
Committee on Oversight and Government Reform  
United States House of Representatives  
2157 Rayburn House Office Building  
Washington, DC 20515

Dear Chairman Issa:

This responds to your letter of March 22, 2011 concerning capital formation. As you know, facilitating capital formation, along with protecting investors and maintaining fair and orderly markets, is the mission of the Securities and Exchange Commission.

Cost-effective access to capital for companies of all sizes plays a critical role in our national economy. Regardless of the form or size of the offering, companies seeking access to capital in the U.S. markets should not be overburdened by unnecessary or superfluous regulations. At the same time, all offerings must, of course, provide the necessary information and protections to give investors the confidence they need to invest in our markets. Striking the right balance between facilitating access to capital by companies and protecting investors in our rules and orders is a critical goal of the SEC.

Our requirements need to be periodically reviewed to ensure that they are up-to-date and costs and benefits remain appropriately calibrated. For example, as described in more detail below, at my request the staff is taking a fresh look at our rules to develop ideas for the Commission about ways to reduce the regulatory burdens on small business capital formation in a manner consistent with investor protection. In this review, we will seek input from many sources, including a new Advisory Committee on Small and Emerging Companies that the Commission is in the process of forming.

Your letter sets out a series of questions on a variety of capital formation-related topics. In an effort to respond to your inquiries in an organized fashion, I have grouped my responses in the following categories: communications in connection with securities offerings, capital formation and regulatory environment, initial public offerings, triggers for public reporting, new capital raising strategies, investments in start-ups, and future steps.

In addition, you also seek certain studies authored or co-authored by current or former staff of the Commission's Office of Economic Analysis ("OEA"), now the Commission's Division of Risk, Strategy and Financial Innovation ("Risk Fin"), concerning registered and unregistered equity capital formation. Attached as Appendix A is a list of studies responsive to

this request. I also am enclosing a disc Bates-numbered SEC\_RF\_OGR\_000001 through SEC\_RF\_OGR\_000452 that contains the listed studies. Beyond these studies, the staff has identified an additional study that appears responsive to your request, but which also appears to contain non-public information. For that study, we will seek to provide it to you after receiving the approval of the Commission.

### **Communications in Connection with Securities Offerings**

Regulation of communications in connection with offerings, whether public or private, begins with the Securities Act of 1933 (“Securities Act”). The Securities Act provides that each offering of securities must be registered with the Commission unless an exemption from registration is available. The degree and means by which an issuer may communicate publicly during the offering process depend on whether the offering is registered under Section 5 of the Securities Act or exempt from registration and, if exempt, the conditions of the particular exemption on which the issuer is relying.

#### **Registered Offerings**

Under the Securities Act, for registered offerings, an issuer’s ability to communicate publicly varies as it proceeds through the registration process, which has three phases:

- the period prior to the filing of a Securities Act registration statement (“pre-filing period”);<sup>1</sup>
- the period between the filing of the Securities Act registration statement and the effectiveness of that registration statement (“waiting period” or “quiet period”); and
- the period after the effectiveness of the Securities Act registration statement (“post-effective period”).

During the pre-filing period, an issuer may not “offer” securities.<sup>2</sup> The term “offer” is broadly-defined under the Securities Act<sup>3</sup> and has been interpreted as going well beyond the

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<sup>1</sup> The Securities Act does not state when the pre-filing period begins. The Commission has stated that an issuer will be in registration at least from the time it begins preparing the related registration statement or the time it has reached an understanding with an underwriter, even if all the terms or conditions of the underwriting arrangement have not been agreed upon. See Release No. 33-5009, *Publication of Information Prior to or After the Filing and Effective Date of a Registration Statement Under the Securities Act of 1933* (October 7, 1969); Release No. 33-5180, *Guidelines for Release of Information by Issuers Whose Securities Are in Registration* (August 16, 1971).

<sup>2</sup> See Securities Act § 5(c).

<sup>3</sup> See Securities Act § 2(a)(3) (“The term ‘offer to sell’, ‘offer for sale’, or ‘offer’ shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.”). See also Release No. 33-3844, *Publication of Information Prior to or After the Effective Date of a Registration Statement* (October 8, 1957); Release No. 33-4697, *Offers and Sales of Securities by Underwriters and Dealers* (May 28, 1964); Release No. 33-5009, *Publication of Information Prior to or After the Filing and Effective Date of a*

common law concept of “offer.”<sup>4</sup> During the quiet period, an issuer can make oral offers but cannot make written offers other than through the use of a prospectus that complies with Securities Act Section 10.<sup>5</sup> The prospectus includes comprehensive, balanced information about the issuer and the offering which facilitates investment decisions. As the term “offer” has been broadly construed, in the absence of rules exempting particular communications, issuers should limit communications before and during offerings to avoid being deemed to make illegal offers. Failure to comply with these requirements is sometimes referred to as “gun-jumping.”

Once in the post-effective period, an issuer can sell and deliver securities as long as a final prospectus that complies with Securities Act Section 10(a) accompanies or precedes the delivery of the securities.<sup>6</sup> Issuers also can send written offers, such as supplemental sales literature, if they are accompanied or preceded by a Section 10(a) prospectus.

Over the years, the Commission has taken steps to facilitate continued communications around public offerings. For example, as early as 1970, the Commission adopted safe-harbor exemptions to make it clear that continued analyst research coverage does not constitute an unlawful offer.<sup>7</sup>

In one of the most important reforms of the registration and offering process, the Commission in 2005 adopted a comprehensive set of new rules and amendments to facilitate capital formation and relax restrictions on communications by issuers during the registered offering process.<sup>8</sup> These changes significantly liberalized an issuer’s ability to communicate publicly during offerings, thereby allowing more information to reach investors. These liberalizations included:

- *Pre-Filing Communications.* To avoid unnecessary limitations on communications by issuers prior to registered offerings, the Commission adopted Securities Act Rule 163A to provide eligible issuers with a bright-line safe harbor for communications made more

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*Registration Statement Under the Securities Act of 1933* (October 7, 1969); Release No. 33-5180, *Guidelines for Release of Information by Issuers Whose Securities Are in Registration* (August 16, 1971).

<sup>4</sup> See, e.g., *Diskin v. Lomasney & Co.*, 452 F.2d 871 (2d. Cir. 1971); *SEC v. Cavanagh*, 1 F. Supp. 2d 337 (S.D.N.Y. 1998).

<sup>5</sup> See Securities Act § 5(b)(1).

<sup>6</sup> See Securities Act § 5(b)(2).

<sup>7</sup> See Release No. 33-5101, *Adoption of Rules Relating to Publication of Information and Delivery of Prospectus by Broker-Dealers Prior to or After the Filing of a Registration Statement Under the Securities Act of 1933* (November 19, 1970).

<sup>8</sup> See Release No. 33-8591, *Securities Offering Reform* (July 19, 2005), <http://www.sec.gov/rules/final/33-8591.pdf>.

than 30 days before the filing of a registration statement, thereby reducing the risk of these communications violating the gun-jumping provisions of the Securities Act.

- *Ordinary Course Business Communications.* The Commission adopted two new rules to provide issuers, including non-reporting companies, with greater certainty that their continuing communications of factual business information will not run afoul of the gun-jumping provisions of the Securities Act.<sup>9</sup>
- *Free Writing Prospectuses.* The Commission adopted new rules to permit written offers outside the statutory prospectus<sup>10</sup> – such as e-mails, faxes and pre-recorded electronic communications, called “free writing prospectuses”<sup>11</sup> – to be made to offer securities in certain circumstances.<sup>12</sup>
- *Media Communications and Publications.* Recognizing that the media can be a valuable source of information about issuers and to encourage the role of the media as a communicator of information, the Commission determined that when an issuer or offering participant provides information to the media about the issuer or the registered offering that ordinarily would be viewed as an “offer,” the media publication is generally treated as a free writing prospectus of the issuer or offering participant in question (provided the media publication is unpaid and unaffiliated with the issuer).<sup>13</sup>
- *Relaxation of Restrictions on Written Offering-Related Communications.* The Commission expanded the scope of the existing safe harbors of Securities Act Rules 134 and 135 to allow issuers to communicate more details about contemplated offerings without those communications being deemed to be “prospectuses” or “offers,” respectively.
- *Research Reports Safe Harbors.* The Commission adopted rule amendments that expanded the scope of the safe harbors for the use of research reports during registered

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<sup>9</sup> See Securities Act Rules 168 and 169. Rule 168 provides eligible reporting issuers with the ability to communicate not only factual business information but also forward-looking information that is regularly released in the ordinary course of business. Rule 169 allows all eligible issuers, including non-reporting companies, to continue to communicate factual business information that they regularly release in the ordinary course of their business without such information being viewed as an impermissible “offer.”

<sup>10</sup> Prior to the adoption of the new rules, issuers were able to make written offers after the filing of a registration statement only in the form of a statutory prospectus.

<sup>11</sup> See Securities Act Rule 405.

<sup>12</sup> See Securities Act Rules 163, 164, and 433.

<sup>13</sup> See Securities Act Rules 164 and 433(f).

offerings.<sup>14</sup> The amendments were designed to encourage the publication of research reports, which provide the market and investors with valuable information about issuers.

- *Relaxation on Restrictions on Offers for Well-Known Seasoned Issuers.* The Commission adopted Rule 163 to enable the largest of the reporting issuers (“well-known seasoned issuers,” or “WKSIs”), which are likely to have the highest degree of market following, to make offers of securities before the filing of the related registration statements.<sup>15</sup>

In your letter, you referenced the initial public offerings of Google, Inc. and The Go Daddy Group, Inc. in connection with the quiet period rules as they relate to initial public offerings, indicating that the quiet period rules delayed the initial public offering of Google and may have resulted in Go Daddy canceling its planned initial public offering.

In April 2004, less than a week before Google initially filed its registration statement for its initial public offering, Google’s two founders were interviewed by *Playboy* magazine. Google informed the staff of the interview in August 2004 and advised the staff that the interview would appear in the September 2004 issue of *Playboy*, which was scheduled to hit newsstands after the offering period for Google’s innovative “Dutch auction”<sup>16</sup> initial public offering closed. Under the rules in effect at the time of this offering, the publication of an article such as this in connection with an initial public offering could raise concerns about inappropriate market conditioning and the potential need for a cooling-off period. For a variety of reasons, primarily based on (1) the timing of the release of the article after the completion of the offering period for the auction; and (2) Google filing the article as an exhibit to its registration statement (thereby including it as part of its offering materials), the staff determined that the publication of the article would not inappropriately condition the market for Google’s initial public offering. As such, the staff did not impose any cooling-off period or otherwise delay the offering as a result of the article. Beyond this, it is important to note that, had the 2005 communications rules described above been in effect at the time, even if the *Playboy* article was published before Google’s offering period for the auction had closed, Google’s initial public offering would not have been delayed.

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<sup>14</sup> See Securities Act Rules 137, 138, and 139.

<sup>15</sup> See Securities Act Rule 163.

<sup>16</sup> A “Dutch auction” initial public offering differs from the “bookbuilding” manner in which initial public offerings typically are made in the United States. In a bookbuilding initial public offering, underwriters gather and assess potential investor demand for a securities offering and seek information important to their determination as to the size and pricing of an issue through soliciting investor interest within a price range. Prospective investors are permitted to revise bids before the bookbuilding closes. In a Dutch auction, the method of pricing an initial public offering is determined by investors expressing their interest level and price threshold, and the offering price is set at the highest level at which all of the shares to be offered can be sold. The Commission took steps to ensure that its rules accommodated the Dutch auction process.

By contrast, another initial public offering in 2004 had a different result under the rules in existence at the time. Salesforce.com, Inc. had planned to go effective on its registration statement in May 2004 when an article appeared in *The New York Times* featuring an interview with the company's CEO.<sup>17</sup> The CEO had invited a reporter to follow him for a day during the road show for the offering, and the article, which was published during the road show, included substantial information about the offering. It appeared to the staff that the interview was granted – and the reporter was given access to the road show process – in an effort for Salesforce.com or its CEO to communicate with prospective investors through the article, which was not permitted under the rules at that time. To address gun-jumping concerns, the staff imposed a cooling-off period. Under the communications rules adopted in 2005, this media coverage would not have required delay of the offering if certain filings, such as filing a copy of the article or its contents as a free-writing prospectus, were made.

Go Daddy filed its registration statement for its initial public offering on May 12, 2006 and withdrew it less than three months later on August 8, 2006. The request for withdrawal cited “unfavorable market conditions” as the reason for the termination of the offering. Although the staff does not have additional first-hand information as to the reasons for the Go Daddy decision to cancel its planned initial public offering, a posting on the blog of Bob Parsons, the chief executive officer of Go Daddy, cited a number of reasons, including the quiet period rules, for the decision.<sup>18</sup> Mr. Parsons' objections to the quiet period rules appear to have rested, at least in part, on his understanding that the rules imposed restrictions on his ability to conduct his weekly radio show.<sup>19</sup> In point of fact, our communication restriction rules would not have prevented Mr. Parsons from conducting his show, but would have prevented him from using the radio show to promote the offering. In liberalizing the communications rules in 2005, the Commission determined that, in the case of initial public offerings, investors should be provided a prospectus before issuers are permitted to market an offering through radio or television in order to assure a balanced presentation.

#### Offerings Not Registered Under the Securities Act

In offerings that are exempt from registration under Section 5, the extent to which an issuer may communicate publicly depends on the requirements of the exemption upon which the issuer is relying. One of the most commonly-used exemptions is Section 4(2) of the Securities Act, which exempts transactions by an issuer “not involving any public offering.” Currently, an

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<sup>17</sup> Gary Rivlin, *It's Not Google. It's That Other Big I.P.O.*, *The New York Times*, May 9, 2004.

<sup>18</sup> See Bob Parsons, *Go Daddy Pulls Its IPO Filing! Why I Decided to Pull It*, Bob Parsons' Personal Blog (August 8, 2006), <http://www.bobparsons.me/121/godaddy-pulls-ipo-filing-why-decided-pull.html>. See also Matt Krantz, *IPO Indigestion Grows as Go Daddy Balks*, *USA Today*.com (August 10, 2006), [http://www.usatoday.com/money/markets/us/2006-08-09-ipo-usat\\_x.htm](http://www.usatoday.com/money/markets/us/2006-08-09-ipo-usat_x.htm); Jonathan Berr, *Go Daddy Yanks IPO*, *The Street* (August 9, 2006), <http://www.thestreet.com/story/10302695/go-daddy-yanks-ipo.html>.

<sup>19</sup> See Parsons, *supra* note 18.

issuer wishing to rely on Section 4(2) or its safe harbor – Rule 506 of Regulation D – is generally subject to a ban on the use of general solicitation or advertising to attract investors for its offering.<sup>20</sup> The ban was designed to ensure that those who would benefit from the safeguards of registration are not solicited in connection with a private offering.

The Commission and staff have acted to facilitate capital raising in private offerings by adopting safe harbor rules – such as Rule 506 – and providing guidance with respect to the scope of Section 4(2) and the ban on general solicitation and advertising.

For example, in 2001, the Commission adopted Rule 155, a safe harbor under the Securities Act, to address concerns about a company's ability to abandon a public offering and, instead, raise money in a private offering. Without this safe harbor, the publicity from the public offering could be viewed as inconsistent with a private offering. Under the safe harbor, an issuer that filed a registration statement for a public offering but then determined not to proceed with the public offering can abandon the registration statement and proceed with a private financing provided certain conditions are satisfied.<sup>21</sup> Rule 155 also permits private offerings in certain circumstances to be abandoned and converted into public offerings.<sup>22</sup> Most recently, in 2007, the Commission clarified that filing a registration statement for an offering would not automatically be viewed as a general solicitation for a concurrent private offering. Instead, the analysis should focus on whether the private offering investors were actually solicited through the registration statement.<sup>23</sup> Finally, through its no-action letters, the staff has provided flexibility for the use of

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<sup>20</sup> See Rule 502(c) of Regulation D (“Except as provided in Rule 504(b)(1), neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising...”); Release No. 4552, *Non-Public Offering Exemption*, (November 6, 1962) (“Negotiations or conversations with or general solicitations of an unrestricted and unrelated group of prospective purchasers for the purpose of ascertaining who would be willing to accept an offer of securities is inconsistent with a claim that the transaction does not involve a public offering even though ultimately there may only be a few knowledgeable purchasers.”).

<sup>21</sup> Release No. 33-7943, *Integration of Abandoned Offerings* (January 26, 2001), <http://www.sec.gov/rules/final/33-7943.htm>. The conditions include that (a) no securities were sold in the registered offering; (b) the registration statement is withdrawn; (c) the private offering commences at least 30 days after the registration statement is withdrawn; and (d) certain disclosures are made to the purchasers in the private offering.

<sup>22</sup> The conditions required to convert abandoned private offerings into public offerings include that (a) no securities were sold in the private offering; (b) all private offering activities cease before the registration statement is filed; (c) unless the private offering was made to only accredited or sophisticated investors, at least 30 days has passed since the cessation of offering activity in the private offering before the registration statement is filed; and (d) certain disclosures are made in the registration statement used in the public offering.

In addition, the Commission adopted Securities Act Rule 135c, a safe harbor allowing reporting issuers to notify the public of their planned exempt offerings. Rule 135c allows issuers to disclose basic information about themselves and their offerings, so long as the conditions of the rule are satisfied. See Release No. 33-7053, *Simplification of Registration and Reporting Requirements for Foreign Companies; Safe Harbors for Public Announcements of Unregistered Offerings and Broker-Dealer Research Reports* (April 19, 1994).

<sup>23</sup> See Release No. 33-8828, *Revisions of Limited Offering Exemptions in Regulation D* (August 3, 2007), <http://www.sec.gov/rules/proposed/2007/33-8828.pdf>.

Internet and other modern communication technologies in private offerings without running afoul of the general solicitation ban.<sup>24</sup>

Early this year, it was reported that Facebook and Goldman Sachs & Co. were planning to offer up to \$1.5 billion of securities of Facebook to clients of Goldman Sachs residing both inside and outside the United States. Goldman Sachs intended to conduct the offering in the United States as a private placement in reliance on Section 4(2). The transaction received intense media coverage and public interest and, on January 17, 2011, Goldman Sachs announced that it was limiting the offering to investors outside the United States. Goldman Sachs said it “concluded that the level of media attention might not be consistent with the proper completion of a U.S. private placement under U.S. law.” At no point in time did the staff advise or instruct Facebook or Goldman Sachs that the offering could not be conducted in the United States. Moreover, as noted above, in 2007 the Commission indicated that the proper analysis of whether a general solicitation occurred focused on whether the investors participating in the offering were actually solicited through the activities which could be viewed as a general solicitation or if, for example, the investors were existing clients or those with whom a pre-existing relationship existed.

I recognize that some continue to identify the general solicitation ban as a significant impediment to capital raising.<sup>25</sup> I also understand that some believe that the ban may be unnecessary because offerees who might be located through the general solicitation but who do not purchase the security, either because they do not qualify under the terms of the exemption or because they choose not to purchase, would not be harmed by the solicitation.<sup>26</sup> At the same time, the general solicitation ban has been supported by others on the grounds that it helps prevent securities fraud by, for example, making it more difficult for fraudsters to attract

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<sup>24</sup> See, e.g., IPONET (July 26, 1996) (general solicitation is not present when previously unknown investors are invited to complete a web-based generic questionnaire and are provided access to private offerings via a password-protected website only if a broker-dealer makes a determination that the investor is accredited under Regulation D); Lamp Technologies, Inc. (May 29, 1998) (posting of information on a password-protected website about offerings by private investment pools, when access to the website is restricted to accredited investors, would not involve general solicitation or general advertising under Regulation D).

<sup>25</sup> See, e.g., *Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission* (April 23, 2006), <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>; Joseph McLaughlin, *How the SEC Stifles Investment – and Speech*, *The Wall Street Journal* (February 3, 2011). Concerns about the scope of the Commission’s rules on general solicitation and advertising have been raised by the participants in the annual SEC Government-Business Forum on Small Business Capital Formation. See *2009 Annual SEC Government-Business Forum on Small Business Capital Formation Final Report* (May 2010), <http://www.sec.gov/info/smallbus/gbfor28.pdf>.

<sup>26</sup> See *Pinter v. Dahl*, 486 U.S. 622, 644 (1988) (“The purchase requirement clearly confines §12 liability to those situations in which a sale has taken place. Thus, a prospective buyer has no recourse against a person who touts unregistered securities to him if he does not purchase the securities.”).

investors or unscrupulous issuers to condition the market.<sup>27</sup>

Neither the Commission nor the staff has had occasion to consider the constitutionality of the quiet period rules under the First Amendment. I understand that First Amendment issues have been raised in the context of private offerings, however, in connection with at least one no-action letter request. That request is still pending.

With respect to your question regarding a cost benefit analysis of the quiet period rules, as the Supreme Court recognized in *Lorillard Tobacco Co. v. Reilly*, “[t]he degree to which speech is suppressed – or alternative avenues for speech remain available – under a particular regulatory scheme tends to be case specific.”<sup>28</sup> Thus, the First Amendment implications of the quiet period rules, or any other regulations, are typically best considered in context. For example, no-action or exemptive requests allow consideration both of the precise regulation at issue and the circumstances of the particular offering, and also allow the staff or the Commission to tailor a response to accommodate the interests at stake. Additionally, specific rulemakings would allow a more concrete context in which to consider the interests at issue.

### **Capital Formation and Regulatory Environment**

Over the years, the Commission has taken a number of actions to facilitate capital raising by companies of all sizes and to reduce burdens on companies when making securities offerings. From the introduction of shelf registration of delayed and continuous offerings in the 1980’s, to the reduction of the eligibility threshold for shelf registration in the early 1990’s, to modernizing communications and the offering process in 2005, the Commission has regularly considered and implemented changes to its rules to reduce regulatory burdens on the offering process while maintaining necessary investor protections provided under the Securities Act. The Commission also has undertaken efforts specifically designed to facilitate capital formation by smaller companies by simplifying the regulatory environment for them. Most recently, the Commission adopted a variety of rules facilitating capital raising for small business in public and private offerings. These rules adopted by the Commission:

- simplified the disclosure and reporting requirements for smaller companies and expanded the ability to use less burdensome, scaled disclosure to more companies;<sup>29</sup>

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<sup>27</sup> See, e.g., J. William Hicks, *Exempted Transactions Under the Securities Act of 1933* § 7:160 (2d ed. 2002); Comment Letter from Investment Companies Institute to SEC (October 9, 2007), <http://www.sec.gov/comments/s7-18-07/s71807-37.pdf> (warning that unlimited general solicitation would “make it difficult for investors to distinguish between advertisements for legitimate offerings and advertisements for fraudulent schemes”).

<sup>28</sup> 533 U.S. 525, 563 (2001).

<sup>29</sup> See Release No. 33-8876, *Smaller Reporting Company Regulatory Relief and Simplification* (December 19, 2007), <http://www.sec.gov/rules/final/2007/33-8876.pdf>.

- liberalized the eligibility requirements for certain short-form registration statements and, as a consequence, shelf registration, to allow eligible smaller public companies to benefit from the greater flexibility and efficiency in accessing the public securities markets;<sup>30</sup>
- adopted a rule specifying that employee stock options generally are not required to be considered a class of equity securities for purposes of triggering the registration requirements under Section 12(g) of the Exchange Act,<sup>31</sup> thereby providing certainty to private companies that granting options to more than 500 employees under their employee stock option plans will not require them to become reporting companies;
- implemented electronic filing of the information required by Form D, making it possible, once the states complete implementation of their electronic filing system, for companies to enjoy the benefits of “one stop” filing in private and other exempt offerings;<sup>32</sup>
- amended Rule 144 – the rule that, among other things, provides a Securities Act safe harbor for resales of privately placed securities – to shorten the holding period and provide other regulatory simplifications.<sup>33</sup>

In addition, the Commission has been mindful of the impact of its rules on small business in connection with its other rulemaking activity. For example, in connection with adopting rule amendments implementing the “say-on-pay” provisions of the Dodd-Frank Act, the Commission provided a two-year phase-in period for smaller reporting companies.<sup>34</sup> This phase-in is a balanced way for the Commission to determine whether its rules would disproportionately burden smaller reporting companies and make any needed changes before the rules become applicable to them. The Commission also, as part of its Dodd-Frank Act rulemaking, recently issued a rule proposal to modify the calculation of “net worth” for purposes of the “accredited investor” definition to exclude the value of an individual’s primary residence when calculating

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<sup>30</sup> See Release No. 33-8878, *Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 and F-3* (December 19, 2007), <http://www.sec.gov/rules/final/2007/33-8878.pdf>.

<sup>31</sup> See Release No. 34-56887, *Exemption of Compensatory Employee Stock Options from Registration Under Section 12(g) of the Securities Exchange Act of 1934* (December 3, 2007), <http://www.sec.gov/rules/final/2007/34-56887.pdf>.

<sup>32</sup> Release No. 33-8891, *Electronic Filing and Revision of Form D* (February 6, 2008), <http://www.sec.gov/rules/final/2008/33-8891.pdf>.

<sup>33</sup> Release No. 33-8869, *Revisions to Rules 144 and 145* (December 6, 2007), <http://www.sec.gov/rules/final/2007/33-8869.pdf>.

<sup>34</sup> See Release No. 33-9178, *Shareholder Approval of Executive Compensation and Golden Parachute Compensation* (January 25, 2011), <http://www.sec.gov/rules/final/2011/33-9178.pdf>

net worth.<sup>35</sup> In developing the proposal, the Commission was mindful of the potential burden on small businesses and drafted the proposal to balance concerns relating to the impact on small businesses and the regulatory purpose of the proposal by allowing debt secured by an individual's primary residence, up to the value of such primary residence, to be excluded from the net worth calculation, thereby deducting only the equity value in the primary residence in the net worth calculation. Before we adopt the final rule, the Commission and staff will carefully weigh the public comments to ensure we strike the right balance.

#### Economic and Cost-Benefit Analyses and Expansions of the Private Markets

Economic and cost-benefit analyses are fundamental components of the rulemaking process and an essential part of the staff's work. The cost-benefit analyses included as part of all rulemaking releases typically are initially drafted by staff from the division or office responsible for the subject matter of the rule. The staff from that division or office who are most familiar with the details and intended operation of the proposed rule consult with the Commission's economists in Risk Fin (formerly OEA) to identify the proposed rule's possible costs and benefits, and to develop an analysis that takes into account the relevant data and economic literature. This collaboration, along with input from other divisions and offices, as appropriate, helps shape the draft economic and cost-benefit analyses included in any draft proposing release. Once senior members of the division primarily responsible for the rule and Risk Fin have reviewed this information, each of the Commissioners review and comment extensively on the draft proposing release. Ultimately, the proposing release, including the economic and cost-benefit analyses, is voted on by the Commission for release to the public.

The Commission invites public comment on all aspects of its proposed rules, including the cost-benefit and economic analyses, and seeks additional empirical data pertinent to these analyses. The rulewriting staff carefully considers all comments and data provided by the public, in close coordination with Risk Fin economists. The staff, along with each of the Commissioners, seek to arrive at a final analysis that takes into consideration the public comments and explains clearly the Commission's regulatory choices.

Your letter also asks whether a risk of diminished regulatory reach for the Commission or the expansion of private markets for accredited investors poses a conflict of interest that prevents the Commission from acting in the best interests of markets and investors. The short but definitive answer is no. In my experience both as Chairman and previously as a Commissioner,

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<sup>35</sup> See Release No. 33-9177, *Net Worth Standard for Accredited Investors* (January 25, 2011), <http://www.sec.gov/rules/proposed/2011/33-9177.pdf>. Section 413(a) of the Dodd-Frank Act requires the Commission to exclude the value of an individual's primary residence when determining if that individual's net worth exceeds the \$1 million threshold required for "accredited investor" status. This change was effective upon enactment of the Act, but the Commission is also required to revise its rules to reflect the new standard. The Commission proposed rule amendments in January that would implement this provision, and would clarify the treatment of any indebtedness secured by the residence in the net worth calculation.

the Commission and its staff seek to act in the best interest of investors and the markets in all the decisions they make. Our mission is to protect investors, maintain fair and orderly markets and facilitate capital formation, and those overriding objectives are what guide our actions. Indeed, this letter clearly outlines actions taken by the Commission in recent years which I believe facilitated capital formation, improved secondary market liquidity and strengthened the private placement market, but which nonetheless resulted in a diminished regulatory role for the Commission.

### **Initial Public Offerings**

The reasons a company may choose to undertake an initial public offering are varied and complex. The reasons often are specific to the company, with each company making the decision as to whether and where to go public based on its own situation and the market factors present at the time.<sup>36</sup> We appreciate that the costs and benefits of the regulatory actions that the Commission takes – and does not take – certainly can impact these decisions. The Commission seeks to minimize the costs of being a public company in the United States and provide a regulatory environment that encourages companies considering going public while at the same time maintaining important investor protections to ensure that investors can responsibly make capital allocation decisions. A vibrant initial public offering market requires that investors have the confidence to invest and that issuers view the benefits of conducting an initial public offering as outweighing the costs.

While the initial public offering market is not as robust as it has been during some periods in the past<sup>37</sup> – or as we would like it to be – it is difficult to identify with precision why any particular company decides to undertake an initial public offering or declines to undertake an offering. Approximately 11 percent of the new issuers filing registration statements for underwritten initial public offerings between January 2009 and March 2011 have withdrawn their registration statements. These companies cited a variety of reasons for terminating their offerings, including unfavorable market conditions, a decision to pursue a merger/acquisition strategy instead of an initial public offering, or simply a decision to not pursue an initial public offering at that time. One company stated that it was withdrawing its registration statement

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<sup>36</sup> See, e.g., A.D. Pruitt, *Some Real-Estate Firms Make IPO U-Turn*, The Wall Street Journal, March 23, 2011 (outlining that real estate companies are choosing to not go public for a variety of reasons, including the return of other sources of capital, access to credit markets and the ability to sell assets to generate capital); David Weild & Edward Kim, Grant Thornton LLP, *Market Structure Is Causing the IPO Crisis — and More* (June 2010) (identifying a series of market structure issues, including technological, legislative and regulatory changes, which have resulted in the decline in the initial public offering market in the United States).

<sup>37</sup> But see PricewaterhouseCoopers LLP, *2010 US IPO Watch Analysis and Trends* (concluding that the U.S. initial public offering markets witnessed a solid recovery in 2010, deal activity in 2010 showed renewed confidence in U.S. initial public offering market, and factors driving 2010 initial public offering activity appear to foretell a healthy market heading into 2011).

because the benefits of being publicly traded were not sufficiently attractive to warrant proceeding with the initial public offering.<sup>38</sup>

The costs associated with conducting an initial public offering and becoming a public reporting company no doubt factor into the decision, and may be particularly challenging for smaller companies. As discussed above, we have taken steps in recent years to lower these costs, and, while more could potentially be done, it is clear that many small companies considering the costs and benefits have opted to access our public capital markets and enter our public reporting system. For example, in fiscal year 2010, approximately 40 percent of first-time registrants identified themselves as smaller reporting companies<sup>39</sup> under our rules, and a similar percentage of all of our reporting companies were identified as smaller reporting companies at the end of fiscal 2010. In fiscal year 2010, nearly half of the registered offerings conducted by first-time registrants (excluding offerings by asset-backed and investment company issuers), were to raise less than \$10 million, and most of those were transactions in which less than \$1 million was raised.

When companies believe the costs of being a public company are likely to outweigh the benefits, the owners are likely to decide to keep the company private. Some of these costs are likely to be more important than others. For example, most often, companies appear to cite the desire to maintain decision-making control and avoid ownership dilution as key concerns when contemplating an initial public offering. Companies also may worry about the potential costs of disclosing vital information publicly, which will become available to competitors. Recent research indicates that companies in industries where it is relatively easy for competitors to appropriate a company's intellectual property tend to remain private.<sup>40</sup> One study found that companies that had completed initial public offerings ranked the costs of SEC reporting requirements and officer liability introduced by the Sarbanes-Oxley Act of 2002 ("SOX") fairly low on the list of factors that affected their decision whether to conduct an initial public offering.<sup>41</sup>

A protracted decline in the stock market is likely to diminish the net benefits of an initial public offering and increase the attractiveness of remaining private. By the same token, availability of cheaper sources of funding (e.g., public or private debt) might allow the company

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<sup>38</sup> *Telegent Systems, Inc.*, Registration Withdrawal Request (Form RW) (May 6, 2010).

<sup>39</sup> Smaller reporting companies are companies with less than \$75 million in public float or, where public float is not calculable, less than \$50 million in revenue for the last fiscal year. See Release No. 33-8876, *Smaller Reporting Company Regulatory Relief and Simplification* (December 19, 2007), <http://www.sec.gov/rules/final/2007/33-8876.pdf>.

<sup>40</sup> See J. Farre-Mensa, *Why Are Most Firms Privately Held?*, Working paper, Harvard University (2011).

<sup>41</sup> See J. Brau and S. Fawcett, *Initial Public Offerings: An Analysis of Theory and Practice*, *Journal of Finance* 61, 399-436 (2006).

to continue to grow while remaining private. Recent research also has shown that companies with less diversified controlling shareholders have comparatively more to gain from further shareholder diversification than those that already have diversified shareholders, and thus are more likely to go public.<sup>42</sup>

Timing also is of great importance. Companies tend to go public when business conditions are good, profitability and valuations are high, and the cost of capital is low.<sup>43</sup> Empirical evidence suggests that stock market valuations, industry conditions, and the need for capital to continue growing are the main factors that influence the timing of an initial public offering. A company might delay its initial public offering if it feels the market conditions are not favorable or investors are not willing to invest in certain types of businesses. Companies also tend to go public when companies with similar business models are overvalued and analysts may be overoptimistic about growth prospects of these companies.<sup>44</sup> Studies on withdrawn initial public offerings find that deteriorating market and industry conditions are by far the main reason for the withdrawal.<sup>45</sup>

Economic theory predicts that private early-stage or speculative growth companies that seek an initial public offering will have greater difficulty raising capital than otherwise similar publicly-traded companies. A variety of factors support this proposition. First, such early-stage/speculative growth entities do not disclose information regularly or on the scale that public companies do, increasing the information asymmetry between the management of these companies and their potential investors. Management could exploit this asymmetry to, for example, fund riskier projects than were promised to investors or exert lower effort, since investors could not monitor them in the way they could a public company. The risks associated with limited disclosure will tend to cause investors to demand higher incentives in return for providing their capital, increasing the cost of financing. In addition, early-stage/speculative growth companies generally have smaller and more variable cash flows than mature, public companies, limiting their ability to finance their growth from their own business operations. Finally, early-stage/speculative growth entities have a smaller asset base and larger percentage of

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<sup>42</sup> See A. Bodnaruk, E. Kandel, M. Massa, and A. Simonov, *Shareholder Diversification and the Decision to Go Public*, *Review of Financial Studies* 21, 2779-2824 (2008).

<sup>43</sup> See H. Choe, R. Masulis, and V. Nanda, *Common stock offerings across the business cycle: Theory and evidence*, *Journal of Empirical Finance* 1, 1-29 (1993); M. Baker and J. Wurgler, *The equity share in new issues and aggregate stock returns*, *Journal of Finance* 55, 2219-2257 (2000); L. Pastor and P. Veronesi, *Rational IPO Waves*, *Journal of Finance* 60, 1713-1757 (2005); W. Kim and M. Weisbach, *Motivations for Public Equity Offers: An International Perspective*, *Journal of Financial Economics* 87, 281-307 (2008).

<sup>44</sup> See R. Rajan and H. Servaes, *Analyst Following of Initial Public Offerings*, *Journal of Finance* 53, 507-529 (1997); J. Ritter and I. Welch, *A Review of IPO Activity, Pricing, and Allocations*, *Journal of Finance* 57, 1795-1828 (2002).

<sup>45</sup> See J. Brau and S. Fawcett, *supra* Note 41.

intangible assets than do mature entities, making them difficult to value and providing less collateral for financing than would be typical of a comparable public company.

Several reports have raised the possibility that the U.S. market is losing its competitive edge to foreign markets with respect to being a market for global initial public offerings,<sup>46</sup> pointing out the decrease in the number of global initial public offerings listing on U.S. exchanges. Other studies, by contrast, note that the perceived disadvantage of the United States might not hold when the size of the global issues that list in the U.S. is taken into consideration.<sup>47</sup> For example, one recent study conducted by SEC staff members (included on the enclosed disc) indicates that for the period 1995-2007, the U.S. market's share of global initial public offerings, in terms of total dollar proceeds and average dollar proceeds, is much higher than those of the United Kingdom and Hong Kong markets.<sup>48</sup>

Compliance costs alone do not seem to explain the choice by the average global initial public offering company not to list in the United States. The evidence suggests a decline in the relative liquidity of the U.S. market attributable primarily to an increase in the liquidity of equity markets in other developed countries.<sup>49</sup> As between the United States and Europe, one reason global initial public offerings might favor Europe is that underwriters charge significantly lower fees to conduct initial public offerings in Europe than in the United States. For initial public offerings with aggregate offering sizes of between \$25 million and \$100 million, the gross spread in the United States has been consistently approximately 7 percent, while for European initial public offerings of the same size it is approximately 4 percent.<sup>50</sup>

Although it appears that there was a sharp increase in the rate at which issuers have gone private since the enactment of SOX, it appears that the rate at which such issuers remained Exchange Act reporting companies following a going private-transaction significantly increased between 2003-2006.<sup>51</sup> Some literature indicates that there was an increase in going-dark

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<sup>46</sup> See, e.g., D. Weild and E. Kim, *A Wake Up Call for America*, Grant Thornton LLP (2009); Committee on Capital Markets Regulation, *Continued Erosion in Competitiveness of the U.S. Public Equity Markets* (2009).

<sup>47</sup> See C. Doidge, A. Karolyi, and R. Stulz, *Has New York Become Less Competitive than London in Global Markets? Evaluating Foreign Listing Choices Over Time*, *Journal of Financial Economics* 91, 253-277 (2009); C. Caglio, K. Weiss Hanley, and J. Marietta-Westberg *Going Public Abroad: The Role of International Markets for IPOs* (February 2011).

<sup>48</sup> See C. Caglio, K. Weiss Hanley, and J. Marietta-Westberg, *supra* note 46.

<sup>49</sup> See M. Halling, M. Pagano, O. Randl, and J. Zechner, *Where Is the Market? Evidence from Crosslistings in the U.S.*, *The Review of Financial Studies* 21, 725-761 (2008).

<sup>50</sup> See M. Abrahamson, T. Jenkinson, and H Jones, *Why Don't U.S. Issuers Demand European Fees for IPOs?*, forthcoming in *Journal of Finance* (2010).

<sup>51</sup> See R. P. Bartlett, *Going Private but Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going Private Decisions*, *U. Chicago L. Rev.*, Vol. 76, 10, 31 (2009).

transactions in 2003-2004,<sup>52</sup> which may be due to increased SOX costs, although several academic researchers argue that the link between SOX and going-dark or going-private decisions in the United States is somewhat doubtful.<sup>53</sup> The increase in going private transactions could be attributable to the strong leveraged buy-out activity fueled by easily accessible credit in the period from 2002-2007. There is academic literature that suggests that SOX has had limited effect on decisions to engage in these types of transactions.<sup>54</sup>

Overall, the effect of SOX on the likelihood that the average U.S. public company will delist appears slight, although several empirical studies have found that small companies are more likely to go private and go dark after SOX, and increased compliance costs under SOX could explain that phenomenon.<sup>55</sup> These studies also suggest that controlling insiders, especially in companies with relatively weak corporate governance, tend to take the companies private and then go dark to protect their private benefits of control. Empirical studies of the impact of SOX on the decision to go public generally indicate that SOX compliance costs are not a major deterrent, even for companies that withdraw their initial public offerings.<sup>56</sup> It is too soon to begin to assess the overall economic effects of the Dodd-Frank Act on decisions to undertake an initial public offering or on delistings.

Recent empirical studies suggest that the delisting of foreign companies from U.S. exchanges is driven mainly by changes in the characteristics of the issuers rather than a general decrease in the competitiveness of U.S. equity markets or the enactment of SOX.<sup>57</sup>

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<sup>52</sup> See C. Leuz, A. Triantis & T.Y. Wang, *Why do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations*, J. Acct. & Econ., Vol. 45, 181-208 (2008). See also, J. L. Coles, *Disclosure Policy: A Discussion of Leuz, Triantis and Wang (2008) on "Going Dark"*, J. Acct. & Econ., Vol. 45, 209-20 (2008).

<sup>53</sup> See, e.g., Leuz, Triantis & T. Wang, *supra* note 52.

<sup>54</sup> See C. Leuz, *Was the Sarbanes-Oxley Act of 2002 Really this Costly? A Discussion of Evidence from Event Returns and Going-private Decisions*, Journal of Accounting and Economics 44, 146-65 (2007); R. Bartlett, *Going Private but Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going-private Decisions*, University of Chicago Law Review 76, 7-44 (2009). See also, P. Iliev, *The Effect of SOX Section 404: Costs, Earnings Quality and Stock Prices*, J. Fin., Vol. -LXV(3), 1163-96, at 1176 (2010); G. A. Karolyi, *Discussion of A Lobbying Approach to Evaluating the Sarbanes-Oxley Act of 2002*, J. Acct. Res., Vol. 47(2), 585-95 (2009).

<sup>55</sup> See L. Austen and D. Dickens, *SOX Doomsday Predictions in Hindsight: Evidence from Delisting*, Current Issues in Auditing I, 21-27 (2007); E. Engel, R. Hayes, and X. Zhang, *The Sarbanes-Oxley Act and Firms Going Private Decisions*, Journal of Accounting and Economics 44, 116-45 (2007); B. Hansen, G. Pownall, and X. Wang, *The Robustness of the Sarbanes-Oxley Effect on the U.S. Capital Market*, Review of Accounting Studies 14, 404-39 (2009); C. Leuz, A. Triantis, and T. Y. Wang, *supra* note 52..

<sup>56</sup> See J. Brau and S. Fawcett, *supra* note 41.

<sup>57</sup> See C. Doidge, A. Karolyi, and R. Stulz, *Has New York Become Less Competitive than London in Global Markets? Evaluating Foreign Listing Choices Over Time*, Journal of Financial Economics 91, 253-277 (2009); C. Doidge, A. Karolyi, and R. Stulz, *Why Do Foreign Firms Leave U.S. Equity Markets?*, Journal of Finance 65, 1507-

### **Triggers for Public Reporting**

Section 12(g) of the Exchange Act was adopted in 1964 following a rigorous special study of the securities markets in the early 1960s, commissioned by Congress and conducted by the Commission.<sup>58</sup> Section 12(g) was enacted to “improve investor protection by extending to the larger companies in the over-the-counter market the registration, reporting, proxy solicitation, and insider trading requirements . . . applicable to companies listed on an exchange.”<sup>59</sup> Section 12(g) requires a company to register its securities with the Commission, within 120 days after the last day of its fiscal year, if, at the end of the fiscal year, the securities are “held of record” by 500 or more persons and the company has “total assets” exceeding \$10 million.<sup>60</sup> Shortly after Congress adopted Section 12(g), the Commission adopted rules defining the terms “held of record” and “total assets.”<sup>61</sup> The definition of “held of record” counts as holders of record only persons identified as owners on records of security holders maintained by the company in accordance with accepted practice. The Commission used this definition to simplify the process of determining the applicability of Section 12(g) by allowing a company to look to the holders of its securities as shown on records maintained by it or on its behalf, such as records maintained by the company’s transfer agent.<sup>62</sup>

Securities markets have changed significantly since the enactment of Section 12(g). Also, since the definition of “held of record” was put into place, a fundamental shift has occurred

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1553 (2010); J. D. Piotroski & S. Srinivasan, *Regulation and Bonding: The Sarbanes-Oxley Act and the Flow of International Listings*, *Journal of Accounting Research* 46, 383-425 (2008).

<sup>58</sup> *Report of Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 88-95, pt. 3 (1963) [hereinafter *Special Study*]. According to the Committee Report summarizing the results of the Special Study, “There is no convincing reason why the comprehensive scheme of disclosure that affords effective protection to investors in the exchange markets should not also apply in the over-the-counter market. . . . [B]ecause the over-the-counter market includes not only securities of widely known and seasoned companies but also those of relatively unknown and insubstantial ones, the need of investors for accurate information is at least as great, if not greater than in the exchange markets.” S. Rep. No. 88-379, at 9 (1963).

<sup>59</sup> Report of the Committee on Banking and Currency to Accompany S.1642, S. Rep. No. 88-379, at 1 (1963).

<sup>60</sup> See Exchange Act § 12(g)(1); Exchange Act Rule 12g-1. When Section 12(g) was enacted, the asset threshold was set at \$1 million. The asset threshold was most recently increased to \$10 million in 1996. Release No. 34-37157, *Relief from Reporting by Small Issuers* (May 1, 1996), <http://www.sec.gov/rules/final/34-37157.txt>.

<sup>61</sup> Release No. 34-7492, *Adoption of Rules 12g5-1 and 12g5-2 Under the Securities Exchange Act of 1934* (January 5, 1965). Issuers may terminate registration and suspend reporting by filing a certification that their securities are held of record by fewer than 300 persons or are held of record by fewer than 500 persons and the issuer’s total assets have not exceeded \$10 million on the last day of each of the most recent three fiscal years. See Exchange Act § 12(g)(4); Exchange Act Rule 12g-4.

<sup>62</sup> See Release No. 34-7492, *Adoption of Rules 12g5-1 and 12g5-2 Under the Securities Exchange Act of 1934* (January 5, 1965).

in how securities are held in the United States. Today, the vast majority of securities of publicly-traded companies are held in nominee or “street name.” This means that the brokers that purchase securities on behalf of investors typically are listed as the holders of record. One broker may own a large position in a company on behalf of thousands of beneficial owners. However, since the shares are all held “in street name,” those shares count as being owned by one “holder of record.” This shift has meant that for most publicly-traded companies, much of their individual shareholder base is not counted under the current definition of “held of record.” Conversely, the shareholders of most private companies, who generally hold their shares directly, are counted as “holders of record” under the definition. This has required private companies that have more than \$10 million in total assets and that cross the 500 record holder threshold – where the number of record holders is actually representative of the number of shareholders – to register and commence reporting. At the same time, it has allowed a number of public companies, many of whom likely have substantially more than 500 shareholders, to stop reporting, or “go dark,” because there are fewer than 500 “holders of record” due to the fact that the public companies’ shares are held in street name. I believe that both the question of how holders are counted and how many holders should trigger registration need to be examined.<sup>63</sup>

Section 12(h) provides the Commission broad authority to exempt issuers from the registration requirements of Section 12(g) so long as the Commission finds that the action is not inconsistent with the public interest or protection of investors.<sup>64</sup> Additionally, Congress has provided the Commission broad exemptive authority in Section 36 of the Exchange Act.<sup>65</sup> The Commission has previously established exemptions from the Section 12(g) requirement,<sup>66</sup> and Section 12(g) provides the Commission with authority to define the terms “held of record” and “total assets.”<sup>67</sup> The Commission therefore has the requisite authority to revise the shareholder threshold if it concludes that doing so is not inconsistent with the public interest or protection of investors.

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<sup>63</sup> Many have called for change in the thresholds that subject a private company to have to register and report under Section 12(g) of the Exchange Act, *see, e.g.,* Azam Ahmed, *Dealbook: Goldman-Facebook Deal Raises Debate on Investor Pool*, *The New York Times* (January 6, 2011), and at least some in Congress have proposed increasing the Exchange Act’s 500 holder limit with respect to certain types of entities. S. 556, 112th Cong. (2011).

<sup>64</sup> *See* Exchange Act § 12(h). The Commission has previously relied on Section 12(h) to raise the total assets threshold.

<sup>65</sup> The Commission “may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.” Exchange Act § 36.

<sup>66</sup> *See* Exchange Act Rule 12g3-2.

<sup>67</sup> “The Commission may for the purpose of this subsection define by rules and regulations the terms ‘total assets’ and ‘held of record’ as it deems necessary or appropriate in the public interest or for the protection of investors in order to prevent circumvention of the provisions of this subsection.” Exchange Act § 12(g)(5).

The Commission has exercised this authority in the past to liberalize the application of Section 12(g). For example, in 2007, the Commission adopted Rule 12h-1(f) under the Exchange Act, which provides an exemption from the held of record threshold for compensatory stock options. As described above, this exemptive rule allows private companies to provide compensatory stock options to employees, officers, directors, consultants and advisors without triggering the need to register those options under the Exchange Act.<sup>68</sup> In addition, in developing an approach for Section 12(g) with respect to foreign issuers, the Commission recognized the practical problems of enforcement and compliance and of differing foreign laws.<sup>69</sup>

The Commission and the staff have been informed by a wide range of proposals relating to possible amendments to Section 12(g) reporting standards that have been advanced by a variety of proponents. Some of these proposals seek to reduce the number of issuers required to report pursuant to the Exchange Act by, for example, raising the shareholder threshold,<sup>70</sup> or by excluding accredited investors, qualified institutional buyers (“QIBs”) or other sophisticated investors from the calculation.<sup>71</sup> On the other hand, other proposals would increase the number of issuers required to report. For example, the Commission has received a rulemaking petition

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<sup>68</sup> Release No. 34-56887, *Exemption of Compensatory Employee Stock Options from Registration Under Section 12(g) of the Securities Exchange Act of 1934* (December 3, 2007), <http://www.sec.gov/rules/final/2007/34-56887.pdf>. The staff of the Division of Corporation Finance also issued a no-action letter extending the relief to restricted stock units due to the similarities between them and stock options. See *Facebook, Inc.* (October 14, 2008).

<sup>69</sup> Release No. 34-7427, *Adoption of Reg. §240.12g3-1* (September 15, 1964). There is a two-part exemptive scheme for foreign private issuers. The first, under Rule 12g3-2(a), is an additional registration threshold based on the number of holders who are resident in the United States, whereby a foreign private issuer is exempt from Section 12(g) if it has fewer than 300 holders resident in the United States, which is in addition to the 500 shareholder of record and \$10 million asset thresholds. The second, under Rule 12g3-2(b), is a self-executing exemption that is based on information availability and the existence of a foreign primary market for a foreign issuer’s securities, which requires the foreign private issuer be listed on a foreign securities exchange where at least 55 percent of its trading takes place and that it posts on the Internet, in English, material information required in its home market. A “foreign private issuer” is defined under Rule 3b-4(c) as any issuer incorporated in a foreign jurisdiction except an issuer that (i) has more than 50 percent of its outstanding voting securities held by U.S. residents and (ii) meets certain criteria relating to the citizenship/residency of officers of directors, the location of the administration of its business and the location of its assets.

<sup>70</sup> In a November 12, 2008 letter, the American Bankers Association made the argument that the 500-shareholder threshold should be increased to reduce the regulatory hardship suffered by small community banks. See Comment Letter from American Bankers Association to SEC (November 12, 2008), <http://www.sec.gov/rules/petitions/4-483/4483-21.pdf>. More recently, Senator Hutchinson, with the support of the American Bankers Association, sought to establish a 2000 holder threshold for banks in the Dodd-Frank Act. 156 Cong. Rec. S3172-01, at \*S3262 (Westlaw) (text of proposed amendment). As mentioned previously, Senator Hutchison recently submitted the same provisions in a separate bill. S. 556, 112th Cong. (2011).

<sup>71</sup> See 2009 Annual SEC Government-Business Forum on Small Business Capital Formation Final Report (May 2010), <http://www.sec.gov/info/smallbus/gbfor28.pdf>.

requesting that the Commission revise the “held of record” definition to look through record holders to the underlying beneficial owners of securities that would prevent issuers from ceasing to report in certain circumstances.<sup>72</sup>

To the extent that the Commission and the staff develop recommendations or proposals regarding changes to reporting thresholds, the consequences of any such proposed change will be subject to rigorous analysis as to the impact on investor protection and capital formation and the other costs and benefits of any proposed change.

Your letter also raises concerns about Rule 12g5-1(b)(3). Rule 12g5-1(b)(3) is an anti-circumvention provision that states that “[i]f the issuer knows or has reason to know that the form of holding securities of record is used primarily to circumvent the provisions of Section 12(g) or 15(d) of the Act, the beneficial owners of such securities shall be deemed to be the record owners thereof.” Rule 12g5-1(b)(3) has been invoked sparingly.<sup>73</sup> The provision is not designed to create uncertainty for issuers. Rather it is meant to prevent companies that would otherwise be subject to registration from evading important investor protections by using artificial means to keep the number of investors below the thresholds that require registration, such as by creating holding companies or other special purpose entities.

You also ask about the use of special purpose vehicles (“SPVs”) to allow investors to have access to investments in companies that have not yet completed initial public offerings. The staff has noted this relatively recent trend as well, and has been exploring a variety of issues raised by it. For example, SPVs may be formed by firms unaffiliated with the issuer and without issuer involvement because the sponsor believes there is demand for exposure to the issuer that cannot be met with shares available in the market.<sup>74</sup> Some of these SPVs trade in the private secondary markets. In other cases, an issuer may work with a sponsor to form the SPV to allow investment in the issuer’s securities.

SPVs that hold private company securities raise a number of policy questions. For example, should our rules count the holders of the SPV in determining whether registration

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<sup>72</sup> See Petition for Commission Action to Require Exchange Act Registration of Over-the-Counter Equity Securities (July 3, 2003), <http://www.sec.gov/rules/petitions/petn4-483.htm>. On February 24, 2009, Mr. Lawrence Goldstein, writing on behalf of Santa Monica Partners L.P., an institutional investor, submitted a follow-up rulemaking petition urging the Commission to count beneficial owners instead of record holders to prevent companies with large numbers of holders from exiting the reporting system. See Petition from Lawrence Goldstein to SEC (February 24, 2009), <http://www.sec.gov/rules/petitions/2009/petn4-483-add.pdf>.

<sup>73</sup> The staff is aware of only one opinion interpreting Rule 12g5-1(b)(3), where the court concluded that an employee’s trust consisting of hundreds of beneficiaries that voted in favor of certain charter amendments was not a “device created to avoid having the employee beneficiaries included as shareholders of record,” the court noted that the trust “clearly serve[d] other important purposes.” *Tankersley v. Albright*, 514 F.2d 956, 969-70 (7th Cir. 1975).

<sup>74</sup> An issuer may be limiting the trading in its securities for a variety of reasons, including a desire to retain control of the company and to assure that it does not cross the 500 holder threshold and trigger registration and reporting.

under Section 12(g) should be required? Should that be the case only if the issuer is involved in forming the SPV? If SPV investors are not counted, does this approach undermine the goals of Section 12(g)? Should our rules under Section 12(g) be amended to address these questions, whether to provide additional certainty or to require registration without regard to the purpose of the SPV? On the other hand, does the formation of these SPVs and investors' interest in them suggest underlying problems with our rules that should be addressed? If the SPVs are traded on private markets, should some level of information be required? These are important questions that I look forward to considering.

Your letter asked if the Commission or its staff intended to influence Facebook or Twitter to undertake initial public offerings. The staff does not advise or influence any company about whether it should proceed with, or indicate the appropriate timing for when a company should commence, the initial public offering process.

You also expressed concerns in your letter about Rule 144A, which provides a non-exclusive safe harbor from the registration requirements of the Securities Act for specified resales of restricted securities to QIBs. When Rule 144A was proposed in 1988, the Commission recognized the need to address the resale market for restricted securities and to remove "uncertainties as to the legitimacy of resales to institutional buyers by providing a safe harbor from registration."<sup>75</sup> Although the focus of Rule 144A is on resales, the staff has long been aware that Rule 144A has also become a means to raise capital. In these "Rule 144A transactions," issuers will sell eligible securities in private placements to broker-dealers who purchase as principals, and the broker-dealers in turn will resell the securities to investors in reliance on Rule 144A. There are few limitations as to the type of securities that are eligible for resale pursuant to Rule 144A.<sup>76</sup> As a result, there is no limitation under the terms of Rule 144A on the ability of a private U.S. company to use Rule 144A to carry out equity financings. As with other offerings of securities by non-reporting companies, issuers using a Rule 144A placement must be mindful of the number of holders in light of the Section 12(g) thresholds. While this may restrict the utility of Rule 144A for issuers seeking to attract large numbers of buyers of their common stock, this issue is best addressed through consideration of the Section 12(g) thresholds as described above.

The staff also is currently monitoring the secondary trading activity on a variety of online trading platforms, many of which are facilitating the trading of securities of private companies. Trading that develops on online trading platforms can be beneficial in that it can provide much desired liquidity to investors, which can assist in attracting investors to smaller private companies. This benefit, however, must be balanced with investor protection concerns that can

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<sup>75</sup> See Release No. 33-6806, *Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145* (October 25, 1988).

<sup>76</sup> Under Rule 144A, the subject securities must not be of the same class as a listed security and the issuer of the subject securities must be reporting under the Exchange Act or agree to provide certain basic information about itself to investors, or be a foreign private issuer that qualifies for the exemption under Rule 12g3-2(b).

be raised when there is a lack of information available to investors about these private companies. Trading markets, including these online platforms, can operate more efficiently where adequate information is available to investors. In the absence of an informed market, concerns can be raised that pricing of securities may be influenced by conflicted market participants who may be buying and selling for their own account as well as facilitating transactions for other buyers and sellers.

### **New Capital Raising Strategies**

Your letter also discusses “crowdfunding,” a possible new method of capital formation that is gaining in popular support.

As we understand it, the term “crowdfunding” is used, generally, to describe a form of capital formation whereby groups of people pool money, typically comprised of very small individual contributions, to support an effort by others to accomplish a specific goal. This funding strategy was initially developed to fund such things as films, books, music recordings and charitable endeavors. At that time, the “investors” were more akin to contributors and were either simply donating funds or were offered a “perk,” such as a copy of the related book or recording. As these funding strategies did not offer an opportunity for profit participation, initial crowdfunding efforts did not raise issues under our securities laws.

Interest in crowdfunding as a capital formation strategy that offers investors an ownership interest in a developing business and the promise of an opportunity for a return on invested capital is growing. An example of crowdfunding described to the staff would be to conduct an offering of up to a maximum of \$100,000 of equity securities of a company, with a cap on individual investments of \$100.

Proponents of crowdfunding are advocating for exemptions from the registration requirements under the Securities Act to permit additional avenues to raise capital for early stage companies and small businesses.<sup>77</sup> The staff also has been discussing crowdfunding and possible

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<sup>77</sup> The Commission received a rulemaking petition on July 1, 2010 from the Sustainable Economies Law Center asking for a crowdfunding exemption from registration under the Securities Act, with a \$100,000 offering limit and a \$100 maximum investment limit. Petition from Sustainable Economies Law Center to SEC (July 1, 2010), <http://www.sec.gov/rules/petitions/2010/petn4-605.pdf>. The petition has received almost 150 comment letters, all in favor of the creation of such an exemption, with some offering different thresholds for offering size and/or individual investment limits. The comment letters are available at <http://www.sec.gov/comments/4-605/4-605.shtml>. Some of the proposals seek to change the definition of an “accredited investor” or create a new definition of an investor that can participate in offerings of small businesses. Section 413(b) of the Dodd-Frank Act authorizes the Commission to undertake a review of the “accredited investor” definition, and mandates that the Commission review the definition in its entirety every four years. Section 415 of the Dodd-Frank Act commissions a study by the Comptroller General to examine “the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds.” The Comptroller General study is due in July 2013.

regulatory approaches to this developing capital formation strategy with business owners, representatives of small business industry organizations and state regulators.<sup>78</sup>

In considering whether an exemption from the registration requirements of the Securities Act is appropriate for capital formation strategies like crowdfunding, the Commission will be mindful of its dual responsibilities of facilitating capital formation and protecting investors.

The Commission's rules previously included an exemption (Rule 504) that allowed a public offering to investors (including non-accredited investors) for securities offerings of up to \$1 million, with no prescribed disclosures and no limitations on resales of the securities sold.<sup>79</sup> These offerings were subject only to state blue sky regulation and the anti-fraud and other civil liability provisions of the federal securities laws. In light of investor protection concerns about fraud in the market in connection with offerings conducted pursuant to this exemption, the exemption was significantly revised in 1999.<sup>80</sup> In developing any potential exemption for crowdfunding, it will be important to consider this experience and build in investor protections to avoid the issues created under the prior exemption. For example, the limits on both individual investment and offering amounts contemplated by crowdfunding may reduce the incentives for abuse, but the widespread use of the internet for these types of funding strategies may present additional challenges to investor protection as compared to those that were present when Rule 504 was revised.

In addition, in 1996, the Commission adopted Regulation CE to assist small businesses in California to raise capital. Regulation CE provides a coordinated federal and state exemption in California for sales of securities of up to \$5 million to a qualified purchaser, which is defined to be less restrictive than an accredited investor under Regulation D. The exemption includes suitability standards, more rigorous disclosure requirements and a limit on investment based on net worth. It does, however, permit a broad dissemination of an announcement of the offering, which would not be permitted under most Regulation D offerings. At the time this exemption was adopted, the Commission planned to provide a similar coordinated federal exemption to states that adopted similar exemptions, but no further action has been taken. An advantage of

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<sup>78</sup> For example, crowdfunding was discussed at the Commission's November 2010 Forum on Small Business Capital Formation. Participants in the Forum recommended that the Commission consider implementing a new exemption from Securities Act registration for crowdfunding, which would include offerings of up to \$100,000 and a cap on individual investments not to exceed \$100. In January 2011, representatives from the Division of Corporation Finance's Office of Small Business Policy met with a group from the Small Business & Entrepreneurship Council, which advocates an exemption from registration requirements for crowdfunding offerings meeting specific requirements. In addition, the Office of Small Business Policy and other members of the Division of Corporation Finance staff discussed crowdfunding with representatives from the North American Securities Administrators Association, the organization of state securities regulators, at a conference held on March 28, 2011.

<sup>79</sup> See Release No. 33-6949, *Small Business Initiatives* (July 30, 1992), <http://www.sec.gov/rules/final/6949.txt>.

<sup>80</sup> See Release No. 33-7644, *Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption* (February 25, 1999), <http://www.sec.gov/rules/final/33-7644.txt>.

Regulation CE for capital raising of small businesses is the coordination between federal and state exemptive authority.

### **Investments in Startups**

Startups are different from the typical company in which financial institutions and institutional investors invest because startups are characterized by uncertainty and information asymmetry (*i.e.*, one party to a transaction has more or better information than another) and often have high levels of intangible assets, making it difficult for institutional investors (like QIBs) to value them accurately. They also are inherently risky and require a long-term investment philosophy. Venture capitalists (“VCs”) that invest in startups have developed certain mechanisms that allow them to successfully manage the risks involved in investing in them. Often VCs are active investors that vigorously monitor their investments and participate in the day-to-day operations of their investments, and they frequently are value-added investors because, unlike most institutional investors and other financial intermediaries, they furnish business expertise to their portfolio companies.<sup>81</sup>

### **Future Steps**

I recently instructed the staff to review the impact of our regulations on capital formation for small businesses, specifically focusing on issues such as:

- the restrictions on communications in initial public offerings;
- whether the general solicitation ban should be revisited in light of current technologies, capital-raising trends and our mandates to protect investors and facilitate capital formation;
- the number of shareholders that trigger public reporting, including questions surrounding the use of SPVs that hold securities of a private company for groups of investors; and
- the regulatory questions posed by new capital raising strategies.

This review also will include evaluating the recommendations of our annual SEC Government-Business Forum on Small Business Capital Formation, as well as suggestions we receive through an e-mail box we recently created on our website.<sup>82</sup> In addition, I expect our efforts to benefit from the input of our new Advisory Committee on Small and Emerging Companies.

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<sup>81</sup> See T. Hellmann, and M. Puri, *The Interaction between Product Market and Financing Strategy: The Role of Venture Capital*, *Review of Financial Studies* 13, 959-984 (2000); T. Hellmann, and M. Puri, *Venture Capital and Professionalization of Start-Up Firms: Empirical Evidence*, *Journal of Finance* 57, 169-197 (2002).

<sup>82</sup> The Commission recently created an e-mail box through which we solicit questions, comments and suggestions from the public on “modifying, streamlining, expanding or repealing our existing rules to better promote economic

Please call me at (202) 551-2100 or have your staff call Tim Henseler, Deputy Director of the Office of Legislative and Intergovernmental Affairs, at (202) 551-2015 if you have any questions or comments.

Sincerely,



Mary L. Schapiro  
Chairman

Attachments

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growth, innovation, competitiveness and job creation” while still adhering to our investor protection and fair and orderly markets mandate. *See Reviewing Regulatory Requirements to Ensure They Continue to Promote Economic Growth, Innovation, Competitiveness & Job Creation*, <http://www.sec.gov/spotlight/regulatoryreviewcomments.shtml>.

## Appendix A

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2. Bauguess, Scott W., Slovin, Myron B., and Sushka, Marie E., *Recapitalization as a Restructuring Mechanism at Closely Held Firms* (January 2009).
3. Krishnan, C. N. V., Ivanov, Vladimir I., Masulis, Ronald W. and Singh, Ajai K., *Venture Capital Reputation, Post-IPO Performance and Corporate Governance* (December 2009).
4. Edwards, Amy K. and Hanley, Kathleen Weiss, *Short Selling in Initial Public Offerings* (April 2010).
5. Hanley, Kathleen Weiss and Hoberg, Gerard, *The Information Content of IPO Prospectuses* (June 2010).
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8. Brown, Stephen J., Grundy, Bruce D., Lewis, Craig M. and Verwijmeren, Patrick, *Convertibles and Hedge Funds as Distributors of Equity Exposure* (January 2011).
9. Caglio, Cecilia, Hanley, Kathleen Weiss and Marietta-Westberg, Jennifer, *Going Public Abroad: The Role of International Markets for IPOs* (February 2011).