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

THE CHAIRMAN

May 25, 2011

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

Dear Chairman Issa:

This responds to your letter of April 29, 2011, which includes additional questions related to capital formation.

A number of the questions you raise concern issues that were discussed at the May 10, 2011 Committee on Oversight and Government Reform capital formation hearing. As I stated then, facilitating capital formation, along with protecting investors and maintaining fair and orderly markets, is the mission of the Securities and Exchange Commission. We are committed to striking the right balance in our rules between these goals, and I appreciated the opportunity to testify before the Committee to discuss the steps the Commission is taking to review our rules to determine how the Commission may be able to reduce the regulatory burdens on small business capital formation in a manner consistent with our investor protection mandate.

Your letter sets out a series of questions on (1) the Commission's process for evaluating the costs and benefits of its rules; (2) the impact of private securities class action litigation on capital formation; (3) restrictions on communications in securities offerings; and (4) the triggers for public reporting. My responses below are grouped into these categories.

<u>Cost-Benefit Analysis in Commission Rulemaking</u>

In your letter, you express concern that a conflict of interest exists in connection with the preparation of the Commission's cost-benefit analyses in its rulemaking process because the Commission staff responsible for drafting proposed rules also are involved in preparing the rules' cost-benefit analyses. As described in more detail below, I do not believe such a conflict of interest exists.

In my April 5, 2011 letter to you, I generally described the process by which cost-benefit analyses are prepared for Commission rulemakings. Commission staff members from the division or office responsible for the subject matter of a rule typically are responsible for drafting the initial cost-benefit analysis. In performing this role, these staff members work closely with the Commission's economists in the Division of Risk, Strategy, and Financial Innovation ("Risk

Fin") to identify potential economic impacts, including the costs and benefits, as part of the development of a rule proposal. That collaboration and consultation usually begins at an early stage of the process, and continues as the rule proposal develops. In addition to the division or office with subject matter responsibility and Risk Fin, other divisions and offices will provide input, as appropriate, throughout the process.

Rule proposals are not drafted without consideration of the potential costs and benefits. To the contrary, cost-benefit analyses are a critical component of our rulemaking. Participation by the staff from the division or office with subject matter responsibility in the preparation of the analysis is essential because they have the greatest familiarity with the subject matter of the rules. Their subject matter expertise is combined with the expertise of our economists, resulting in cost-benefit analyses that benefit from the input of all knowledgeable parties. I believe the collaborative manner in which we prepare our cost-benefit analyses is essential for an effective rulemaking process, and results in rule proposals that fully consider each of the Commission's objectives.

It also is important to understand that the cost-benefit analysis prepared by staff in any rule proposal also is subject to extensive additional review and consideration. Before any rule is proposed, the cost-benefit analysis is reviewed and analyzed by the Commissioners and their staffs. Once a rule proposal is published, the Commission invites public comment on the cost-benefit analysis contained in the proposal. The public comments and input that result are taken into consideration by the staff in its preparation of a final rule, which again is reviewed and analyzed by the Commissioners prior to its promulgation.

To your specific question concerning Risk Fin's role, Risk Fin staff will be central to any cost-benefit analysis we conduct as part of rulemaking related to small business capital formation issues, including those related to the triggers for public reporting.

Impact of Securities Class Actions on Capital Formation

Your letter also expressed concerns about private securities class action litigation, specifically noting a January 2007 study sponsored by New York City Mayor Michael Bloomberg and Senator Charles Schumer relating to the competitiveness of New York City as a global financial center.[1] The Bloomberg/Schumer Report recommends that the Commission use its exemptive authority to limit the potential liability of companies and auditors in private securities litigation.[2]

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[1] McKinsey & Co., *Sustaining New York's and the US' Global Financial Services Leadership* (undated, released January 2007) (commissioned by New York City Mayor Michael Bloomberg and U.S. Senator Charles Schumer) (the "Bloomberg/Schumer Report").

[2] *Id.* at 100-104.

The majority of private securities litigation involves alleged violations of the antifraud provisions of the Exchange Act, which courts have interpreted to confer a private right of action. Although the Commission's exemptive authority does permit it to exempt persons, securities or transactions from provisions of the Exchange Act when it finds that the exemption is in the public interest and consistent with the protection of investors, protecting investors from securities fraud is a cornerstone of the securities laws. It is hard to imagine that the Commission would broadly find that the elimination or significant limitation of antifraud liability in either Commission or private actions was "consistent with the protection of investors." To do so would be inconsistent – and indeed antithetical – to the Commission's investor protection mandate.

The Bloomberg/Schumer Report did recommend that Congress enact "legislative reforms to securities laws that will eliminate inappropriate lawsuits without undermining relevant substantive rights."[3] As you know, Congress has legislated in this area over the years, including in 1995 when it enacted broad changes relating to private securities litigation in the Private Securities Litigation Reform Act.[4]

Restrictions on Communications in Securities Offerings

As I indicated in my prior letter, the ban on general solicitation or advertising was designed to ensure that those who would benefit from the safeguards of registration are not solicited in connection with a private offering. I understand there are some who believe the ban on general solicitation is unnecessary because the rules relating to private offerings only permit investors that meet certain financial or other qualifications to actually purchase offered securities, and, therefore, individuals who do not meet those qualifications would not be harmed by a broad public solicitation because they cannot purchase the offered securities. I also recognize that some continue to identify the ban on general solicitation in private offerings as being an impediment to capital formation for small businesses. The ban on general solicitation does, however, make it more difficult for those who are intent on using private placements as a tool to defraud to attract a wide array of investors, including those who may not be "able to fend for themselves,"[5] or to condition the market for their securities.

As I noted both in my testimony before the Committee and my prior letter to you, I have asked the staff to consider this issue as part of its review of the ban on general solicitation. This review will look at the ban's impact on capital formation, including the cost of capital and availability of investment opportunities, and the investor protection benefits provided by the ban. The review will be conducted by the Division of Corporation Finance with the assistance of Risk

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[3] *Id.* at 100.

[4] *See* Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in sections of 15 U.S.C. §§ 77, 78)

[5] *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953).

Fin, as well as other appropriate divisions and offices. As part of this review, staff will seek input from the Advisory Committee on Small and Emerging Companies, which currently is being formed by the Commission. In addition, staff will gather input from outside the Commission – from companies, investors and other interested parties – relating to the costs and benefits of the application of the ban on general solicitation in the marketplace. Additionally, to the extent the Commission and staff develop recommendations for proposed changes to the ban on general solicitation, the consequences of any such changes will be subject to rigorous analysis, including an analysis of the impact of any proposed changes on investor protection, capital formation and any other costs or benefits.

Your letter raised questions regarding the potential First Amendment implications of the ban on general solicitation. We recognize that the ban on general solicitation does in fact limit speech to some extent, and we therefore must be cognizant of the potential First Amendment interests at stake. However, as I indicated previously, the First Amendment implications of our regulations are best considered in particular contexts.

The prohibition on general solicitation is one criterion determining qualification for an exemption from the registration requirement in the Securities Act and therefore must be analyzed in the context of the registration and disclosure regime created by that Act, as well as the risks to investors that Congress intended to address in enacting it.[6] The ban on general solicitation, despite a prohibition on selling unregistered securities to unqualified investors, is in some ways not unlike the regulations at issue in *Lorillard Tobacco Co. v. Reilly*, which restricted the advertisement of tobacco products to minors despite a prohibition on selling those products to minors. The Court in *Lorillard* recognized that the additional protections provided by the limitations on advertising continued to advance substantial government interests.[7] While the Court struck down the advertising restrictions at issue in *Lorillard* as insufficiently narrowly tailored, the Commission and the staff have, as described in my prior letter to you, adopted rules and provided interpretive guidance that has permitted speech without contravening the policy underlying the registration requirement.[8] The staff will continue to be cognizant of this issue as part of its review of the ban on general solicitation. The view you have articulated in your letters and those of other commentators who have similarly questioned the ban also will be considered as part of that review. Specifically, the staff will consider, under the standards applicable to commercial speech, whether the current limitations on general solicitation continue to serve a

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[6] Congress determined in the Securities Act that a prophylactic regime in which offers could not be made absent registration was appropriate given the risk of fraud in securities offerings. The limitations on private offerings are consistent with that prophylactic regime.

[7] 533 U.S. 525, 556-61 (2001).

[8] For example, the staff has issued no action letters and interpretive guidance that make clear how the Internet can be used in private offerings of securities without running afoul of the prohibitions on general solicitation and general advertising.

substantial government interest and, if so, whether they are appropriately tailored to meet that interest.

The pending no-action letter request referenced in my prior letter is still open and under consideration by the staff. The issues raised in the no-action letter request relating to the ban on general solicitation will be considered as a part of the review of the ban discussed above.

Triggers for Public Reporting

As I noted in my prior letter to you, when the thresholds for public reporting were added by Section 12(g) of the Exchange Act in 1964,[9] Congress relied on a study of the securities markets conducted by the Commission in the early 1960's.[10] The study included a survey of over 2,000 issuers that sought data on, among other things, asset levels, securities offerings, shares outstanding, shareholders of record and the number of shares held by large shareholders. The data derived from the study was used to develop recommendations as to the best metrics upon which to base the triggers for public reporting.

The securities markets have gone through profound changes since Section 12(g) was added to the Exchange Act. To enable the Commission to properly consider the issues related to the thresholds for triggering public reporting – and those for leaving the public reporting system – I believe we need a robust study akin to the one conducted prior to Section 12(g)'s enactment. The staff has begun the preparatory work for such a study.

Your letter raised a number of important questions relating to the triggers for public reporting, including:

- What impact does the record holder trigger for public reporting have on the available investor base for small businesses?
- Are there substantial additional capital raising transaction costs for small businesses as they try to manage shareholder numbers so as not to trigger a public reporting obligation?
- What impact does a company's management of shareholder numbers to prevent triggering a public reporting obligation have on its ability to compensate its employees with equity interests?
- What impact does the record holder trigger for public reporting have on the liquidity of shares of private companies? What impact does this have on capital formation of small businesses?

[9] Report of the Committee on Banking and Currency to Accompany S.1642, S. Rep. No. 88-379, at 1 (1963).

[10] Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 88-95, pt. 3 (1963).

These are some of the questions that the staff will analyze in connection with its review of the triggers for public reporting. As part of this review, the staff also will analyze the related thresholds that allow companies to stop public reporting, or "go dark."

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

Mary L. Schapiro
Chairman