ONE HUNDRED TWELFTH CONGRESS

Congress of the United States

House of Representatives

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

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April 29, 2011

The Honorable Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street Northeast
Washington, D.C. 20549

Dear Chairman Schapiro:

Thank you for your letter dated April 6, 2011, in which you responded to my concerns regarding capital formation. I appreciate your efforts to enable the public to know the issues facing U.S. capital markets and the steps that the Securities and Exchange Commission (SEC) intends to take to improve the future outlook for capital formation in our country. It is clear that the Commission put a great deal of effort into its response.

I ask that you would continue your commitment to capital formation by answering additional questions. Please consider these issues in advance of the Committee's upcoming hearing on capital formation on May 10, 2011 and provide written responses by May 25, 2011.

Cost-Benefit Analysis

The SEC recently failed a GAO audit of its internal controls. One of the central themes in creating the proper internal controls environment is the tone from the top. To the extent SEC management permits conflicts of interest, it does not set the proper tone. I am concerned that the SEC's process relating to cost-benefit analysis reflects a serious conflict of interest. I am also concerned that the process does not place sufficient authority with the staff most qualified to perform cost-benefit analysis. I ask that you consider improving controls surrounding this extraordinarily important function.

In your response to my March 22, 2011, letter, you described the SEC's process for evaluating the costs and the benefits of regulations.[1]

[1] Schapiro Response at 11.

> 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.

I have two concerns:

First, from your response it is clear that those responsible for drafting a rule also evaluate its costs and benefits. The fact that economists are "consulted" fails to shift control of the analysis to the economists. If staff and management of a particular division supported the drafting of a particular rule, that same staff and management are conflicted when asked to evaluate the costs and the benefits of their own rule. This process results in a clear conflict of interest.

My second concern is that, unlike Ph.D. economists, attorneys generally are not trained to perform cost-benefit analysis. If economists do not manage the cost-benefit analysis, this calls into question the credibility of analysis.

In light of my concerns:

1. Please explain what actions you will take to eliminate the conflict of interest that exists in preparing cost-benefit analyses at the SEC.

2. In your letter at page 20 you state that "[t]o 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."

   Please explain whether you plan to assign Risk Fin economists to fully perform the cost-benefit analysis relating to potential regulatory changes to the 499-shareholder cap.

Impact of Securities Class Actions on Capital Formation

As the Committee continues to review securities regulation, a major concern is the health of our capital markets, whether public or private. A study sponsored by U.S.

Senator Charles Schumer (D- NY) and New York City Mayor Michael Bloomberg found that securities class action litigation harms the competitiveness of U.S. capital markets.[2]

The fundamental problem is that diversified investors are just as likely to be the beneficiaries of an alleged fraud (because they were able to sell securities at an artificially inflated price) as they are to be harmed by the fraud (because they purchased at the inflated price), yet in all these cases, the attorneys get paid very well.[3] As one article explains, "[p]rivate securities lawsuits in the United States ... often just transfer losses from one innocent group of shareholders to another innocent group, with large fees obtained by the lawyers for both sides."[4]

Securities class action judgments and settlements do not require beneficiaries of the fraud to disgorge profits (except in the case of insider trading).[5] Instead, the issuer pays, unfairly impacting current shareholders.[6] As Professor John C. Coffee, Professor of Law at Columbia University, has observed,

> "[i]nevitably, the settlement cost imposed on the defendant corporation in a securities class action falls principally on its shareholders. This means that the plaintiff class recovers from the other shareholders, with the result that secondary market securities litigation largely generates pocket-shifting wealth transfers among largely diversified shareholders.[7]

In trying to determine whether any worthwhile benefits result from securities class action cases, the motives of class action attorneys and public enforcers must be considered. While securities class action attorneys are motivated by profits, public enforcers do not have the same incentives. The incentive to maximize profit generally

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[2] Hal Scott, *Canaries in a Coal Mine Competitive Complacency in the Decline of America's Public Equity Capital Markets*, May 1, 2007.

[3] Patrick Dynes, *Study Regarding Aiding and Abetting Liability Mandated by Section 929Z of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, Chamber of Commerce, p. 9-11 (April 4, 2011).

[4] Roe & Jackson, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, Harvard Law School John M. Olin Center for Law Economics and Business Discussion Paper Series, Paper No. 638, at 5 (Apr. 2009) (also published in the Journal of Financial Economics, vol. 93 (2009)).

[5] *Study Regarding Aiding and Abetting Liability Mandated by Section 929Z of the Dodd-Frank Wall Street Reform and Consumer Protection Act* at 10.

[6] *Id.*

[7] John C. Coffee, *Law and the Market*, p. 304; *see also* Coffee, *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534, 1556-61 (2006); Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate over Entity Versus Individual Liability*, 42 WAKE FOREST L. REV. 627, 632 (2007.

leads to extracting settlements from innocent shareholders. This fails to create value; instead it drives up the cost of capital, pushing issuers to other markets.

In fact, it is hard to determine which is the greater fraud – the violation of securities laws, or the extraction of settlements from innocent shareholders. When the U.S. capital markets were the envy of the world, we could afford the additional costs of such meritless schemes. This is no longer the case.

If the SEC eliminated these duplicative private actions it would save the capital markets billions of dollars each year. The SEC should act to prevent this drain of liquidity from our securities markets. Chairman Schapiro, you are uniquely positioned to effect this change, and given your responsibility to promote capital formation, I ask that you consider substantially reforming securities class action litigation.

3. Please provide a comprehensive cost-benefit analysis that considers the impact of securities class action litigation on capital formation.

The Quiet Period and the Ban on General Solicitations

In recent years, the public equity markets have grown highly competitive, as evidenced by a move to decimalization.[8] Falling revenues reduced broker-dealers' incentive to provide analyst coverage for small issuers, reducing liquidity for the shares of many small issuers.[9] Specialists, those that maintain a "fair and orderly market" in specified securities, also previously provided substantial liquidity to small issuers.[10] The decline of specialists (now designated market makers) harmed liquidity as well. The loss of analyst coverage and the demise of specialists fundamentally altered capital formation in the United States. As an offset to these structural changes in the equity markets, the SEC needs to allow private issuers to advertise or generally solicit accredited investors to raise capital.

In your April 6, 2011, letter, you stated that the ban on general solicitation prohibits advertisements by private issuers "to ensure that those [ordinary investors] who would benefit from the safeguards of registration are not solicited in connection with a

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[8] *See* Hendrik Bessembinder *Trade Execution Costs and Market Quality after Decimalization.* Journal of Financial and Quantitative Analysis, 38, pp 747-777 (2003).

[9] *See* Cliff, Michael, and David Denis, *Do Initial Public Offering Firms Purchase Analyst Coverage with Underpricing?* Journal of Finance 59, 2871-2901 (2004).

[10] Cao, C., Choe, H., Hatheway, F., *Does the specialist matter? Differential execution costs and intersecurity subsidation on the NYSE,* Journal of Finance 52, 1615–1640 (1997). (Within a specialist firm, there is a positive relation between order processing costs and trading activity that is consistent with the hypothesis that active stocks subsidize inactive stocks).

private offering."[11] Your answer suggests that the ban exists simply because such advertisements can reach ordinary investors that are not even eligible to participate. Multiple laws and regulations prevent private issuers from selling shares to ordinary investors.[12] The ban on general solicitation provides no meaningful additional protection to these investors, yet it dramatically alters the way capital is formed in the U.S.

In Question No. 12 of my March 22, 2011, letter, I asked you to explain all potential harm that may realistically result to an unaccredited investor by the receipt of an advertisement or general solicitation by a private issuer that is evaluating all investors to ensure accreditation. Following up on my original request:

4. Please specifically identify how general solicitations would harm those "[ordinary investors] who would benefit from the safeguards of registration."[13]

5. Please ask the Chief Economist of the SEC's Division of Risk, Strategy and Financial Innovation (Risk Fin) to provide a cost-benefit analysis with regard to the ban on general solicitation as it applies to private issuers that have no current plans to go public. The analysis should evaluate the costs and benefits of the ban with regard to capital formation, cost of capital, investment opportunities, and fraud in the context of modern communications and technology. Assume investors are, at a minimum, accredited.

In Question No. 10 of my March 22, 2011, letter, I asked the SEC to consider the constitutionality of the quiet period, including the ban on general solicitation.[14] It greatly concerns me that "[n]either the Commission nor the staff has had occasion to consider the constitutionality of the quiet period rules under the First Amendment" despite my request, and the no-action letter request currently pending with the SEC.[15]

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[11] SEC Response at 7.

[12] *See, e.g.*, Shannon DeRouselle, *Financial Reform Act; Accredited Investors and Venture Capital* (July 21, 2010). (Non-compliance with the securities laws can result in significant monetary and injunctive penalties against a company, including the right of rescission).

[13] *Id.*

[14] See Question Nos. 10, 11 and 12, Issa Letter at 5-6.

[15] *See* SEC Response at 9.

While the Commission cites *Lorillard Tobacco Co. v. Reilly* (Lorillard) to argue the need for case specific facts, this concern should not preclude such an analysis.[16] The SEC has detailed information on many historical quiet period violations that can provide for reasonable case specific facts. The SEC also has Ph.D. economists and ample highly qualified attorneys to perform the necessary economic and legal analysis. The SEC is well-positioned to preemptively evaluate the constitutionality of securities laws and regulations.

6. Please evaluate whether, based on Lorillard, the SEC has been violating the First Amendment rights of private issuers through its enforcement of the prohibition on general solicitation by private issuers. Risk Fin's responses to Question No. 5 above should assist you with this First Amendment analysis.

7. Please prioritize your review of the related pending no-action request, and provide the Committee with the results of that review when completed.

The 499-Shareholder Cap under Section 12(g) of the Exchange Act

I was pleased with your agreement that the 499-shareholder cap needs examination. Specifically, you argued "both the question of how [share]holders are counted and how many holders should trigger registration need to be examined."[17] You also confirmed the broad exemptive authority that Congress provided to the SEC.[18]

In your response, you referenced an *SEC Government-Business Forum on Small Business Capital Formation Final Report* where the idea to "exclude accredited investors, large accredited investors and qualified institutional buyers from the 500 shareholders of record calculation in Section 12(g) under the Securities Exchange Act for purposes of becoming a public company" received substantial support. I appreciate and support your consideration of this alternative. I also support the exclusion of naturally well informed employees of private issuers from application of the shareholder cap.

Imposition of the 499-shareholder cap creates unintended consequences that constrain liquidity, reduce capital formation and increase the cost of capital to private issuers. To protect shareholders from these harms, the SEC should exempt accredited investors, institutional buyers and employees of an issuer from application of the shareholder cap. I list some of the unintended consequences and related issues below.

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[17] Schapiro Response at 18.

[18] *Id.*

8. Please provide your view on the following points:

   a. The 499 cap generally causes issuers to raise capital from relatively larger accredited investors and institutional buyers that can provide sizeable investments. If issuers seek capital from smaller investors, the issuer may not be able to raise enough money before hitting the cap. In effect, the 499-shareholder cap limits investment opportunities to larger accredited investors and institutional buyers.

   b. The 499 cap creates a logistical challenge where issuers carefully manage the total number of shareholders to avoid inadvertently breaching the cap. Management of the number of shareholders requires a time-consuming process that prevents liquidity formation. This inefficient process increases transaction fees and reduces the potential share price.

   c. To manage the logistics of the 499 cap, issuers generally retain a right of first refusal (ROFR) to control the number of shareholders, but this right causes the naturally informed issuer to determine who gets to purchase shares that become available. The issuer's power to choose the buyer combined with its informed position provides an incentive to reward favored purchasers.

   d. The three concerns listed above impede liquidity in the markets for unregistered shares by 1) reducing the number of potential shareholders, 2) increasing the time required to complete transactions and 3) reducing certainty that an offer will be accepted (due to the ROFR).

   e. Discounts resulting from illiquidity increase issuers' cost of capital, reducing the competitiveness of private firms and, by extension, the U.S. economy.

   f. The shareholder cap places the success of many opportunities at risk by reducing the potential for additional capital formation as an issuer approaches 499 shareholders. This limitation increases risks to the issuer, shareholders, and the economy.

   g. Despite investor protections resulting from an employee's naturally informed position, the shareholder cap restricts a private issuers' ability to compensate employees with shares in the company. This restriction eliminates a powerful incentive for improved productivity, reducing returns to the issuer, shareholders and the economy.

The Committee on Oversight and Government Reform (the Committee) is the principal oversight committee of the House of Representatives and has broad authority to investigate "any matter" at "any time" under House Rule X. An attachment to this letter provides additional information about responding to the Committee's request.

We request that you provide the requested information as soon as possible, but no later than 5:00 p.m. on May 25, 2011. When producing documents to the Committee, please deliver production sets to the Majority Staff in Room 2157 of the Rayburn House Office Building and the Minority Staff in Room 2471 of the Rayburn House Office Building. The Committee prefers, if possible, to receive all documents in electronic format.

If you have any questions about this request, please contact Peter Haller or Hudson Hollister of the Committee Staff at 202-225-5074. Thank you for your attention to this matter.

Sincerely,

Darrell Issa
Chairman

Enclosure

cc: The Honorable Elijah E. Cummings, Ranking Minority Member

DARRELL E. ISSA, CALIFORNIA
CHAIRMAN

ELIJAH E. CUMMINGS, MARYLAND
RANKING MINORITY MEMBER

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Responding to Committee Document Requests

1. In complying with this request, you should produce all responsive documents that are in your possession, custody, or control, whether held by you or your past or present agents, employees, and representatives acting on your behalf. You should also produce documents that you have a legal right to obtain, that you have a right to copy or to which you have access, as well as documents that you have placed in the temporary possession, custody, or control of any third party. Requested records, documents, data or information should not be destroyed, modified, removed, transferred or otherwise made inaccessible to the Committee.

2. In the event that any entity, organization or individual denoted in this request has been, or is also known by any other name than that herein denoted, the request shall be read also to include that alternative identification.

3. The Committee's preference is to receive documents in electronic form (i.e., CD, memory stick, or thumb drive) in lieu of paper productions.

4. Documents produced in electronic format should also be organized, identified, and indexed electronically.

5. Electronic document productions should be prepared according to the following standards:

   (a) The production should consist of single page Tagged Image File ("TIF"), files accompanied by a Concordance-format load file, an Opticon reference file, and a file defining the fields and character lengths of the load file.

   (b) Document numbers in the load file should match document Bates numbers and TIF file names.

   (c) If the production is completed through a series of multiple partial productions, field names and file order in all load files should match.

6. Documents produced to the Committee should include an index describing the contents of the production. To the extent more than one CD, hard drive, memory stick, thumb drive, box or folder is produced, each CD, hard drive, memory stick, thumb drive, box or folder should contain an index describing its contents.

7. Documents produced in response to this request shall be produced together with copies of file labels, dividers or identifying markers with which they were associated when they were requested.

8. When you produce documents, you should identify the paragraph in the Committee's request to which the documents respond.

9. It shall not be a basis for refusal to produce documents that any other person or entity also possesses non-identical or identical copies of the same documents.

10. If any of the requested information is only reasonably available in machine-readable form (such as on a computer server, hard drive, or computer backup tape), you should consult with the Committee staff to determine the appropriate format in which to produce the information.

11. If compliance with the request cannot be made in full, compliance shall be made to the extent possible and shall include an explanation of why full compliance is not possible.

12. In the event that a document is withheld on the basis of privilege, provide a privilege log containing the following information concerning any such document: (a) the privilege asserted; (b) the type of document; (c) the general subject matter; (d) the date, author and addressee; and (e) the relationship of the author and addressee to each other.

13. If any document responsive to this request was, but no longer is, in your possession, custody, or control, identify the document (stating its date, author, subject and recipients) and explain the circumstances under which the document ceased to be in your possession, custody, or control.

14. If a date or other descriptive detail set forth in this request referring to a document is inaccurate, but the actual date or other descriptive detail is known to you or is otherwise apparent from the context of the request, you should produce all documents which would be responsive as if the date or other descriptive detail were correct.

15. The time period covered by this request is included in the attached request. To the extent a time period is not specified, produce relevant documents from January 1, 2009 to the present.

16. This request is continuing in nature and applies to any newly-discovered information. Any record, document, compilation of data or information, not produced because it has not been located or discovered by the return date, shall be produced immediately upon subsequent location or discovery.

17. All documents shall be Bates-stamped sequentially and produced sequentially.

18. Two sets of documents shall be delivered, one set to the Majority Staff and one set to the Minority Staff. When documents are produced to the Committee, production sets shall be delivered to the Majority Staff in Room 2157of the Rayburn House Office Building and the Minority Staff in Room 2471of the Rayburn House Office Building.

19. Upon completion of the document production, you should submit a written certification, signed by you or your counsel, stating that: (1) a diligent search has been completed of all documents in your possession, custody, or control which reasonably could contain responsive documents; and (2) all documents located during the search that are responsive have been produced to the Committee.

Definitions

1. The term "document" means any written, recorded, or graphic matter of any nature whatsoever, regardless of how recorded, and whether original or copy, including, but not limited to, the following: memoranda, reports, expense reports, books, manuals, instructions, financial reports, working papers, records, notes, letters, notices, confirmations, telegrams, receipts, appraisals, pamphlets, magazines, newspapers, prospectuses, inter-office and intra-office communications, electronic mail (e-mail), contracts, cables, notations of any type of conversation, telephone call, meeting or other communication, bulletins, printed matter, computer printouts, teletypes, invoices, transcripts, diaries, analyses, returns, summaries, minutes, bills, accounts, estimates, projections, comparisons, messages, correspondence, press releases, circulars, financial statements, reviews, opinions, offers, studies and investigations, questionnaires and surveys, and work sheets (and all drafts, preliminary versions, alterations, modifications, revisions, changes, and amendments of any of the foregoing, as well as any attachments or appendices thereto), and graphic or oral records or representations of any kind (including without limitation, photographs, charts, graphs, microfiche, microfilm, videotape, recordings and motion pictures), and electronic, mechanical, and electric records or representations of any kind (including, without limitation, tapes, cassettes, disks, and recordings) and other written, printed, typed, or other graphic or recorded matter of any kind or nature, however produced or reproduced, and whether preserved in writing, film, tape, disk, videotape or otherwise. A document bearing any notation not a part of the original text is to be considered a separate document. A draft or non-identical copy is a separate document within the meaning of this term.

2. The term "communication" means each manner or means of disclosure or exchange of information, regardless of means utilized, whether oral, electronic, by document or otherwise, and whether in a meeting, by telephone, facsimile, email, regular mail, telexes, releases, or otherwise.

3. The terms "and" and "or" shall be construed broadly and either conjunctively or disjunctively to bring within the scope of this request any information which might

otherwise be construed to be outside its scope. The singular includes plural number, and vice versa. The masculine includes the feminine and neuter genders.

4. The terms "person" or "persons" mean natural persons, firms, partnerships, associations, corporations, subsidiaries, divisions, departments, joint ventures, proprietorships, syndicates, or other legal, business or government entities, and all subsidiaries, affiliates, divisions, departments, branches, or other units thereof.

5. The term "identify," when used in a question about individuals, means to provide the following information: (a) the individual's complete name and title; and (b) the individual's business address and phone number.

6. The term "referring or relating," with respect to any given subject, means anything that constitutes, contains, embodies, reflects, identifies, states, refers to, deals with or is pertinent to that subject in any manner whatsoever.