# THE FUTURE OF CAPITAL FORMATION

# HEARING

BEFORE THE

## COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

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# THE FUTURE OF CAPITAL FORMATION

**TUESDAY, MAY 10, 2011**

HOUSE OF REPRESENTATIVES,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
*Washington, DC.*

The committee met, pursuant to notice, at 12:30 p.m., in room 2154, Rayburn House Office Building, Hon. Darrell E. Issa (chairman of the committee) presiding.

Present: Representatives Issa, McHenry, Lankford, Amash, Buerkle, Gosar, Meehan, Gowdy, Farenthold, Cummings, Towns, Maloney, Norton, Tierney, Cooper, and Connolly.

Staff present: Robert Borden, general counsel; Will L. Boyington and Drew Colliatie, staff assistants; Molly Boyl, parliamentarian; Lawrence J. Brady, staff director; Katelyn E. Christ, research analyst; Benjamin Stroud Cole, policy advisor and investigative analyst; John Cuaderes, deputy staff director; Adan P. Fromm, director of Member liaison and floor operations; Linda Good, chief clerk; Peter Haller, senior counsel; Frederick Hill, director of communications and senior policy advisor; Christopher Hixon, deputy chief counsel, oversight; Hudson T. Hollister, counsel; Ryan Little, manager of floor operations; Justin LoFranco, press assistant; Mark D. Marian, senior professional staff member; Laura L. Rush, deputy chief clerk; Ashley Etienne, minority director of communications; Jennifer Hoffman, minority press secretary; Carla Hultberg, minority chief clerk; Lucinda Lessley, minority policy director; Brian Quinn, minority counsel; Steven Rangel, minority senior counsel; Dave Rapallo, minority staff director; and Susanne Grooms Sachsman, minority chief counsel.

Chairman ISSA. I want to make a couple of brief announcements. First of all, it will not be a breach of decorum with the current temperature if people remove their jackets. I apologize, but when they turn from air conditioning to heat, they do it with a vengeance in this building.

I understand the chairman has to leave at 1:30 so we will be respectful of time. As Members show up, they may or may not get to ask questions.

Madam Chair, I understand you are the only one that is going to be making an opening statement, correct? And that Ms. Cross, I understand we get to keep you for all of the followup questions.

Very good.

I am going to waive the normal mission statement and be very brief in my opening statement.

Today's hearing is in fact about the issue of capital formation. As the chart behind me indicates, the historic public market, the market we think of as the Nasdaq, the New York Stock Exchange, and so on, is no longer producing the number of initial public offerings as it once did. Since 1991, we have seen that avenue for capital formation reduced. Doesn't mean that there aren't plenty of companies who still suit that.

But today we are asking the question of can America continue to build companies of the future if there is not an additional access to capital for those companies of the future? Particularly, we will be asking the question of whether or not a 499 limit of investors on private companies is appropriate or whether there can be administrative or legislative fixes to that.

As a member of a board of a small public company, I am well aware of the cost and difficulties of being public. We are not the Financial Oversight Committee, and we will not assume that we can micromanage what happens in Sarbanes-Oxley, Dodd-Frank, or any of the other legislation that is well known here on the Hill.

Rather, we are thrilled to be in the presence of a distinguished first and second panel that are going to help us understand, in the broad sense of the word, where America is going and what the great stories of tomorrow are.

Many people have looked at the Facebook situation and said, Ha, that is the impetus for this. Nothing could be further from the truth, although it is a high-profile company who only recently went past their 500 investors, it is very clear that is not the model for which we have a concern.

We on the committee are concerned for the small- and medium-sized companies, for companies in which a family or an extended family wish to make sensible plans for the future, allowing diversification and at the same time opportunity for investors.

Additionally, we would like to understand better from Chairman Schapiro what the real future of a qualified investor is versus the investment public as a whole. As all of us know, the SEC has a dual mandate. One of them, of course, is notably the protection of the public. The other is, in fact, what this is about here today, which is capital formation. We hope to come into this and go out of it with the idea that America has an obligation and Congress has an obligation to participate in capital formation that leads to greater employment. And with 9 percent unemployment still lingering with us for over 2 years on and off now, we understand and realize that this is but a small element of it, but it is an important element.

With that, I yield to the ranking member.

Mr. CUMMINGS. Thank you very much, Mr. Chairman. Today's hearing will examine ways to help small and emerging businesses gain access to additional capital, help them grow and hopefully succeed.

This issue is critical to the continuing economic recovery and the future success of our great Nation. If U.S. firms cannot grow, they simply cannot create jobs. Our examination must begin with the simple concept that permits our markets to function effectively, and that is investor confidence. If people or institutions do not have confidence that our market is safe and sound, they simply will not invest. And this lack of confidence will impede the ability of growing companies to access much-needed capital.

This was a key lesson of the 1929 market crash. As a result, Congress created the Securities and Exchange Commission to enforce security laws in a way that enabled firms to access capital while providing investors with sufficient information to have a basic level of confidence in the system.

We learned this lesson again in 2008 as inadequate financial oversight led to recklessness, fraud, and unscrupulous behavior resulting in the greatest financial crisis since the Great Depression. We must never forget that.

The SEC has now charged 66 entities and individuals with securities violations leading to or arising from the recent financial crisis. For example, Goldman Sachs paid a record penalty of $550 million after the SEC charged the firm with, "defrauding investors, defrauding investors by misstating and omitting key facts about a financial product tied to subprime mortgages."

Charles Schwab paid $118 million to settle charges regarding misleading statements the firm made to market a mutual fund "invested in mortgage-backed and other risky securities." As a result, Congress passed the Dodd-Frank Act last year, making critical changes to the U.S. financial regulatory system to enhance accountability for banks and Wall Street firms that caused the financial crisis.

Some people now feel we should repeal these protections in their entirety, as if the crisis that crippled our great Nation and our economy in 2008 never happened. In my opinion, that is exactly the wrong approach and, as a matter of fact, it is shocking to the conscience.

We will not restore lost confidence by removing protections that safeguard investors. Instead, we must find an effective balance—and I thank Commissioner Schapiro for constantly talking about balance—one that ensures investors that they will be protected in the future while carefully examining ways to optimize growth. I fully support helping U.S. firms access additional capital, but I also believe that this must be done without sacrificing critical protections that assure our fellow citizens that our markets are fundamentally sound.

It is important to remember that the investors we are trying to protect are everyday Americans. They are our constituents. In fact, according to an April survey by Gallup, a majority of Americans, 54 percent, reported owning some form of stock.

I am encouraged by the fact that since she has begun her tenure, Chairman Shapiro has taken an active role in guiding her staff to conduct comprehensive reviews over a range of issues concerning capital market formations, including many of the issues that we will discuss here today.

The 25-page letter she sent to the committee on April 6, 2011, demonstrates that she is serious about exploring innovative and new ideas to assist market participants while implementing robust consumer protections that will help investors retain confidence in our markets.

In that letter, she said the following: 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 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.

And with that, I look forward to hearing from the chairlady and our other panelists.

And thank you, Mr. Chairman. I yield back.

Chairman ISSA. All Members will have 7 days to submit opening statements and extraneous material for the record.

We now go to our distinguished panel.

The Honorable Mary Schapiro is chairman of the Securities and Exchange Commission and Ms. Meredith Cross is the director of the SEC's division of corporate finance.

Pursuant to the rules of the committee, I would ask that you both rise to take the oath.

Would the record indicate both witnesses answered in the affirmative.

Again, Chairman Shapiro, we appreciate you making time for this hearing and you're recognized.

**STATEMENTS OF MARY SCHAPIRO, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION; AND MEREDITH CROSS, DIRECTOR OF THE DIVISION OF CORPORATION FINANCE, U.S. SECURITIES AND EXCHANGE COMMITTEE**

## STATEMENT OF MARY SCHAPIRO

Ms. SCHAPIRO. Thank you. Chairman Issa, Ranking Member Cummings, and members of the committee. Thank you for inviting me to testify today on the topic of capital formations. As the chairman has said, I am joined by Meredith Cross, director of the SEC's Division of Corporation Finance, and I regret that a change in the committee schedule for this hearing means that I do have to leave at 1:30 for a longstanding prior engagement. However, Ms. Cross will stay to address any questions the committee might have.

Facilitating capital formation, protecting investors, and maintaining fair, orderly, and efficient markets is the mission of the SEC. Cost-effective access to capital for companies of all sizes plays a critical role in our national economy, and companies seeking access to capital should not be overburdened by unnecessary or superfluous regulations.

At the same time, while we have an important responsibility to facilitate growing companies' access to America's investment capital, we must balance that responsibility with our obligation to protect investors in our markets.

Too often, investors are the targets of fraudulent schemes disguised as investment opportunities. In fiscal year 2010, offering frauds—cases where promoters, issuers, or others defraud investors in the offer of securities—comprised 22 percent of the Commission's cases. Investor confidence and the fairness and honesty of our markets is critical to the formation of capital, and the protections provided by the securities laws are critical to large and small company investors alike.

Over the years, the SEC has taken significant steps consistent with investor protection to facilitate capital raising by companies of all sizes and to reduce burdens on companies in making offerings. From the introduction of shelf registration in the 1980's to the reduction of the eligibility threshold for shelf in the early 1990's to modernizing communications and the offering process in 2005, the SEC regularly considers and, when appropriate, implements changes to our rules to reduce regulatory burdens while maintaining the important investor protections provided under the Securities Act.

The SEC also has undertaken errors specifically designed to facilitate capital formation for smaller companies by simplifying the regulatory environment for them. Most recently in 2007, the SEC adopted a variety of rules impacting small business capital raising and private offerings, a number of which were based on the recommendations of the SEC's then-serving Advisory Committee on Smaller Public Companies.

Among the rules adopted by the Commission were those that simplified the disclosure and reporting requirements for smaller companies and expanded the ability to use less burdensome scale disclosure to more companies, allowed a company to grant stock options to more than 500 employees without triggering the requirements to become a reporting company, and liberalized the eligibility requirements for certain short-form registration statements and some shelf registration to allow eligible smaller public companies to benefit from greater flexibility and efficiency in accessing the public securities market.

Recently I instructed our staff to take a fresh look at our offering rules and to develop ideas for the Commission to consider that would reduce the regulatory burdens on small business capital formation in a manner consistent with investor protection. Areas of focus for the staff will include 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 special-purpose vehicles that hold securities of a private company for groups of investors; and the regulatory questions posed by new capital raising strategies.

In conducting this review, we will solicit input and data from multiple sources including small businesses, investor groups, and the public at large. The review will include evaluating recommendations of our annual SEC Government Business Forum on Small Business Capital Formation and as well as suggestions we receive and have already received through an e-mail box we recently created on our Web site.

In addition, I expect our efforts to benefit from the input of the new Advisory Committee on Small and Emerging Companies that the Commission is in the process of forming, which will provide a formal mechanism for the Commission to receive advice and recommendations about regulatory programs that affect privately held businesses and small publicly traded companies. Any rule proposals that result from this, review will, of course be subject to a public comment period in advance of any rule changes being adopted.

We look forward to working closely with Congress, the investing public, and members of the business community as we explore the possibilities and challenges in these areas and work to fulfill our mandate to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.

We would be happy to answer any questions the committee might have. Thank you.

Mr. ISSA. Thank you.

[The prepared statement of Ms. Schapiro follows:]

**Testimony on the Future of Capital Formation**
**by**
**Chairman Mary L. Schapiro**
***U.S. Securities and Exchange Commission***

**Before the U.S. House of Representatives Committee on Oversight and Government Reform**

**Tuesday, May 10, 2011**

Chairman Issa, Ranking Member Cummings, and members of the Committee:

Thank you for inviting me to testify today on the topic of capital formation.[1]

Facilitating capital formation, along with protecting investors and maintaining fair, orderly and efficient markets, is the mission of the SEC. Cost-effective access to capital for companies of all sizes plays a critical role in our national economy, and companies seeking access to capital should not be overburdened by unnecessary or superfluous regulations. At the same time, while we have an important responsibility to facilitate growing companies' access to America's investment capital, we must balance that responsibility with our obligation to protect investors and our markets. Too often, investors are the target of fraudulent schemes disguised as investment opportunities. In Fiscal Year 2010, offering frauds – cases where promoters, issuers or others defraud investors in the offer of securities – comprised 22 percent of the Commission's cases. Investor confidence in the fairness and honesty of our markets is critical to the formation of capital, and the protections provided by the securities laws are critical to large and small company investors alike.

Over the years, the SEC has taken significant steps, consistent with investor protection, to facilitate capital-raising by companies of all sizes and to reduce burdens on companies in making offerings. From the introduction of shelf registration 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, to the 2007 small business reforms, the SEC regularly considers and, if appropriate, implements changes to our rules to reduce regulatory burdens on the offering process while maintaining important investor protections provided under the Securities Act.

[1] The views expressed in this testimony are those of the Chairman of the Securities and Exchange Commission and do not necessarily represent the views of the full Commission. Testifying with me today will be Meredith Cross, the Director of the Commission's Division of Corporation Finance. I have attached biographical information for Ms. Cross as an appendix to this testimony.

Recently, I instructed our staff to take a fresh look at some of our offering rules to develop ideas for the Commission to consider that would reduce the regulatory burdens on small business capital formation in a manner consistent with investor protection. In conducting this review, we will gather data and seek input from many sources, including small businesses, investor groups, the public-at-large, and a new Advisory Committee on Small and Emerging Companies that the Commission is in the process of forming, so that we consider a variety of viewpoints. Any rule proposals that result from this review, will, of course, be subject to a public comment period in advance of any rule changes being adopted.

I look forward to working with the staff and my fellow Commissioners throughout this process to ensure that our rules continue to provide small businesses with access to investment capital in a manner consistent with the Commission's investor protection mandate.

My testimony provides an overview of a variety of capital formation-related topics, as well as a more detailed description of what lies ahead in terms of the Commission's consideration of capital formation issues.

**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");
- 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.[2] The term "offer" is broadly-defined under the Securities Act and has been interpreted as going well beyond the common law concept of "offer." 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.[3] 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.[4] 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 by issuers and others 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. [5]

In 2005, the SEC implemented significant reforms to modernize the rules governing communications and the registered offering process, known as Securities Offering Reform.[6] The SEC recognized that communications in the capital markets had changed tremendously since the Securities Act was written and the shelf registration system[7] was designed in the 1980s. The changes to the offering and communication process provided in the Securities Offering Reform expanded an issuer's ability to communicate publicly during registered

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[2] *See* Securities Act § 5(c).

[3] *See* Securities Act § 5(b)(1).

[4] *See* Securities Act § 5(b)(2).

[5] *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).

[6] *See Securities Offering Reform*, Release No. 33-8591 (July 19, 2005) and Release No. 33-8591A (February 6, 2006) available at http://www.sec.gov/rules/final/33-8591.pdf and http://www.sec.gov/rules/final/33-8591a.pdf.

[7] The shelf registration system allows a company that meet certain requirements to file a registration statement with the Commission that registers the sale of securities of the company in offerings that could occur later or on a delayed or continuous basis.

offerings, thereby allowing more information to reach investors, while at the same time preserving important investor protections. The changes 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 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.[8]

- *Free Writing Prospectuses.* The Commission adopted new rules to permit written offers outside the statutory prospectus[9] – such as e-mails, faxes and pre-recorded electronic communications, called "free writing prospectuses"[10] – to be made to offer securities in certain circumstances.[11]

- *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 adopted new rules providing that when an issuer or offering participant gives information to the media about itself or a 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).[12] As a result, press articles around the time of an offering that previously could have caused a delay in an offering because they could have been considered gun-jumping can now be published without subjecting an issuer to delay.

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[8] *See* Securities Act Rules 168 and 169.

[9] 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.

[10] *See* Securities Act Rule 405.

[11] *See* Securities Act Rules 163, 164, and 433.

[12] *See* Securities Act Rules 164 and 433(f).

- *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 offerings.[13] 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.[14]

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 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.[15] 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,

[13] *See* Securities Act Rules 137, 138, and 139.

[14] *See* Securities Act Rule 163.

[15] *See* Rule 502(c) of Regulation D.

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.[16] Rule 155 also permits private offerings in certain circumstances to be abandoned and converted into public offerings.[17] 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.[18] Finally, through its no-action letters, the staff has provided flexibility for the use of Internet and other modern communication technologies in private offerings without running afoul of the general solicitation ban.[19]

I recognize that some continue to identify the general solicitation ban as a significant impediment to capital raising for small businesses. I also understand that some believe that the ban may be unnecessary because those who do not purchase the offered security would not be harmed by the solicitation that occurs. At the same time, the general solicitation ban is supported by others on the grounds that it helps prevent securities fraud by making it more difficult for fraudsters to attract investors or unscrupulous issuers to condition the market. We need to balance these considerations as we move forward in analyzing this issue.

**Capital Formation for Smaller Companies**

The SEC also has undertaken efforts specifically designed to facilitate capital formation for smaller companies by simplifying the regulatory environment for them. Most recently, in 2007 the SEC adopted a variety of rules impacting small business capital raising and private

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[16] Release No. 33-7943, *Integration of Abandoned Offerings* (January 26, 2001), http://www.sec.gov/rules/final/33-7943.htm.

[17] 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).

[18] *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.

[19] *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).

offerings, a number of which were based on the recommendations of the SEC's then-serving Advisory Committee on Smaller Public Companies. The 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;[20]
- liberalized the eligibility requirements for certain short-form registration statements and shelf registration to allow eligible smaller public companies to benefit from the greater flexibility and efficiency in accessing the public securities markets;[21]
- adopted a rule that allows a company to grant stock options to more than 500 employees without triggering the requirements under Exchange Act Section 12(g) to become a reporting company;[22]
- implemented electronic filing of the information required by Form D, making it possible once the states complete implementation of the electronic filing system, for companies to enjoy the benefits of "one stop" filing in private and other exempt offerings;[23] and
- amended Rule 144 – the rule that relating to resales of privately placed securities – to shorten the holding period and provide other regulatory simplifications.[24]

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, we provided a two-year phase-in period for smaller reporting companies.[25] This phase-in is a balanced

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[20] *See Smaller Reporting Company Regulatory Relief and Simplification*, Release No. 33-8876 (December 19, 2007) *available at* http://www.sec.gov/rules/final/2007/33-8876.pdf.

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

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

[23] *See Electronic Filing and Revision of Form D*, Release No. 33-8891 (February 6, 2008), http://www.sec.gov/rules/final/2008/33-8891.pdf.

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

[25] *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

way for us to determine whether our rules would disproportionately burden smaller reporting companies and make any needed changes before the rules become applicable to them. In addition, as required by the Dodd-Frank Act, we 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 net worth.[26] In drafting the proposal, we sought to balance concerns relating to the impact on small businesses and the regulatory purpose of the proposal by allowing debt secured by a 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.

Finally, just last Friday, the Commission approved a proposal by Nasdaq OMX BX to establish a new listings market, the "BX Venture Market." The BX Venture Market is designed to allow the securities of smaller companies that are unable to meet the more rigorous listing standards of NYSE and Nasdaq to list and trade on a national securities exchange. We expect that the BX Venture Market will provide an opportunity for smaller businesses to have their securities traded in an environment that offers the potential for enhanced transparency, liquidity and regulatory oversight, which could make these companies more attractive to potential investors. While care must be taken to ensure that less-seasoned issuers are appropriately vetted and surveilled, and that investors understand the differences between these securities and those that are listed on a traditional exchange, the prospect of trading on an exchange could facilitate the ability of smaller companies to raise capital and invest in the growth of their businesses.

**Initial Public Offerings**

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.

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[26] *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. We 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.

We appreciate concerns raised by smaller companies about the costs of compliance with SEC regulations for both public offerings and for ongoing reporting. As described above, the Commission has revised its regulations over the years in an effort to reduce these costs in a manner consistent with investor protection. While more potentially could be done, it is clear that many small companies considering the costs and benefits have elected to become SEC registrants. For example, in fiscal year 2010, approximately 40 percent of first-time registrants identified themselves as smaller reporting companies 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.

**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. 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."[27] 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.[28] Shortly after Congress adopted Section 12(g), the Commission adopted rules defining the terms "held of record" and "total assets."[29] 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.[30]

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

[28] *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.

[29] Release No. 34-7492, *Adoption of Rules 12g5-1 and 12g5-2 Under the Securities Exchange Act of 1934* (January 5, 1965).

[30] *See* Release No. 34-7492, *Adoption of Rules 12g5-1 and 12g5-2 Under the Securities Exchange Act of 1934* (January 5, 1965).

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 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,"[31] 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.

The Commission has exercised its 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.[32] 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.[33]

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[31] A company can "go dark," or terminate the registration of a class of securities under Section 12(g), by certifying to the Commission either that the class of securities is (1) held of record by less than 300 persons or (2) held of record by less than 500 persons where the total assets of the company have not exceeded $10 million on the last day of each of the company's most recent three fiscal years. *See* Exchange Act § 12(g)(4); Exchange Act Rule 12g-4.

[32] 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).

[33] Release No. 34-7427, *Adoption of Reg. §240.12g3-1* (September 15, 1964).

The Commission and 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, or by excluding accredited investors, qualified institutional buyers ("QIBs") or other sophisticated investors from the calculation. On the other hand, other proposals would increase the number of issuers required to report. For example, the Commission has received a rulemaking petition 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.[34]

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.

**Future Steps**

As discussed above, I recently asked the staff to take a fresh look at our offering rules in light of changes in the operation of the markets, advances in technology and the acceleration in the pace of communications. I also requested that the staff think creatively about what the SEC can do to encourage capital formation, particularly for small businesses, while maintaining important investor protections. Areas of focus for the staff will include:

- 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 special purpose vehicles that hold securities of a private company for groups of investors; and
- regulatory questions posed by new capital raising strategies.

[34] *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.

In conducting this review, we will solicit input and data from multiple sources, including small businesses, investor groups and the public-at-large. The review 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.[35] In addition, I expect our efforts to benefit from the input of the new Advisory Committee on Small and Emerging Companies the Commission is in the process of forming, which will provide a formal mechanism for the Commission to receive advice and recommendations about regulatory programs that affect privately held small businesses and small publicly traded companies.

We look forward to working closely with Congress, the investing public, and members of the business community as we explore the possibilities and challenges in these areas, and work to fulfill our mandate to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.

I thank you for inviting me here today, and I look forward to answering your questions.

[35] 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 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.

Chairman ISSA. I'll begin by a round of questioning.

Madam Chair, the chart behind me, which indicates a peak in the note of a pretty large dropoff to where 100, 150 of IPOs is considered a good year, does that indicate to you that the market for large companies, those who are mostly over 200 million that are doing IPOs, is in fact a market of the past; or is it a recognition that it simply costs more to play in that market and those companies are choosing other alternatives?

Ms. SCHAPIRO. Mr. Chairman, I think the numbers reflect the number of different factors that actually go into the decision the companies have to make about doing an initial public offering. Certainly economic conditions are very prominent in that decisionmaking process. There are also issues about whether founders want to give up their decisionmaking control that they exercise as a private company, whether they want to have dilution of their ownership interests. There is a potential disclosure of vital business information when you go public.

Chairman ISSA. I don't want to interrupt you unfairly. But all of those existed in this 1980's and 1990's, so the change can't be those factors. It could be consideration of those factors. But the real change in small companies going public since the 1980's seems to be the cost of going public.

Ms. SCHAPIRO. I think costs of going public are certainly a factor. As I started to say, and I would be happy to supplement the record further, there are lots of factors I think that go into that decision for public companies, and including some of our earlier IPOs up there, I suspect foreign companies going public in the U.S. markets.

And one of the things we've seen, particularly in the last several years is a real maturation of foreign markets that give those foreign-based companies a viable alternative to going public in the United States, which I think is a perfectly rational decision for them to make these markets that we are in now. Liquid have good listing standards, have sophisticated shareholder bases that they may not have had 10 and 20 years ago, as represented by that chart.

The other thing I think that is important when companies, foreign companies make a decision about whether to access the U.S. IPO market is that it's much less expensive in terms of underwriter fees in Europe than it is in the United States. It's about 4 percent gross spread in Europe, whereas it's 7 percent in the United States. So I think there are lots of factors.

Chairman ISSA. Isn't it also true that you have U.S. companies choosing to go public overseas in many cases, thus leaving a lot of your oversight behind? It is not just companies that are truly based overseas but also companies who want to be global, whose CEO is living here, who decides that a foreign market in Canada or in Europe makes more sense for them to do.

Ms. CROSS. I think I can take this.

## STATEMENT OF MEREDITH CROSS

Ms. CROSS. I think there are some companies in that situation, but I think our data, which we are happy to supplement for the record, doesn't suggest there is a significant number of U.S. companies going offshore for their IPOs.

I think other factors that are relevant—certainly we understand that costs are important, and we are committed to looking at those costs. But I think that, for example, the alternative of a sale increased significantly in recent years and has more certainty. So if people are trying to get out of their investment, the private equity market became quite huge in the last decade and that also provided an alternative.

But this isn't to suggest we don't think the costs are important. I just think there are—people have told us there are a number of reasons why companies choose not to go public now.

Chairman ISSA. Let me take a slightly different line, and I know we want to talk about small businesses and the 500 cap and so on. Let me just ask a question.

When people want to float, if you will, public debt, senior debt, and they go through a process of registering debt, it's really a one-time event. You register the debt, it's floated, it's bought up. And then after that, the company that borrows 150 million in senior debt, in fact it views itself as separate from the debt that it repays.

To a great extent, don't we have a disconnect in that a company can say, Look, I'd like to take on investors. I am willing to tell them this, but I'd like to be able to have the ability to run my company with those investors understanding at the time they bought in will not be reported.

So to a certain extent, haven't we lost that middle ground in the public market? You're either all public and you have several million dollars cost to go public and several million a year to be public, or you are private and you find yourself not availing yourself to, if you will, a broad range of investors.

Ms. SCHAPIRO. I guess I would ask Meredith if she wants to add to this. But I think that is basically right. If you choose to become a public company you need to follow the reporting and disclosure requirements of the Federal securities laws. You've taken investors' money. That is part of the bargain that you have struck with investors is that they'll have the opportunity both for board members to participate in a meaningful way, and that they will have access to information on an ongoing basis that will allow them to make decisions about whether to continue to hold that stock or to sell it in the market.

Chairman ISSA. And the reason I asked that question is since we are not getting the IPOs here in the United States, people are choosing not to go into that market. At least for institutional qualified investors, why in the world would we have a 499 cap on how many of them can participate in a company? If you are a sophisticated investor, why couldn't you choose to be involved in what today is available to these leverage organizations and angel capital and other investors who choose to buy a bigger piece rather than one 500?

Ms. SCHAPIRO. Mr. Chairman, that is exactly what our review is really looking at is whether a threshold of 499 or 500 is still appropriate, as well as a review of the threshold at which a company can cease being a reporting company because of the change in the number of its shareholders. And we will, as you know, do a very rigorous study and gather the kind of analysis and data that is necessary for us to analyze whether those thresholds are still appropriate given how markets are operating today.

Chairman ISSA. Thank you.

I recognize the ranking member.

Mr. CUMMINGS. Thank you very much.

Chairman Shapiro, I want to thank you for your responsiveness to this committee. It has been extensive. I want to thank you and your staff, and it's been forthright, and I really do appreciate it, and I think all of us appreciate it.

There has been a lot of discussion about rolling back the protections Congress put in place to safeguard investors in the public. We hear that they are too burdensome, too costly and that they hurt corporate profits. I'd like to return to the fundamental reason we need these safeguards to begin with.

On January 25th there was an article in the Atlantic and it described in detail how executives from Bear Stearns took extreme measures to defraud clients, cheating investors out of billions of dollars through a corrupt "double dipping" scheme. Amazingly, the article also reported that many of the same executives, those responsible for these abuses, are now in top positions at other firms.

Here is what the article said: "Former Bear Stearns mortgage executives who now run mortgage divisions of Goldman Sachs, Bank of America, Allied Financial, have been accused of cheating and defrauding investors through the mortgage securities they created and sold while at Bear."

Chairwoman Shapiro, how can this be? How can the same executives responsible, allegedly responsible for these abuses, now be making millions of dollars running different companies?

Ms. SCHAPIRO. Congressman, as you know, we have a very aggressive enforcement division at the SEC that has under investigation many issues arising out of the financial crisis, and indeed we brought about two dozen cases or so coming out of the financial crisis. You mentioned the Goldman Sachs case. But there are many others that name both firms and individuals, officers, chief financial officers, and others, and we'll continue to investigate those very aggressively.

Wherever the facts and the laws will take us, we will go. And if there are appropriate actions to be brought against particular individuals, we won't hesitate to bring those cases.

Mr. CUMMINGS. The Atlantic article also said this. It said, "Last week, a lawsuit filed in 2008 by mortgage insurer Amback Insurance Co. against Bear Stearns and JP Morgan was unsealed. The lawsuit supporting e-mails going back as far as 2005 highlight Bear traders telling their superiors they were selling investors like Amback a 'sack of shit.'"

Chairman Shapiro, are you aware of those e-mails?

Ms. SCHAPIRO. I am not specifically aware of those e-mails, although I would imagine that our enforcement division is. And I should add that it is not just the SEC that is stepping up here. It's the other financial regulators through the mortgage fraud task force and through efforts in conjunction with the Department of Justice and others to try to bring as many of these cases as we can.

Mr. CUMMINGS. This is astonishing, and, if accurate, they indicate that some of the same executives knew exactly what they were doing and simply didn't care. As I understand it, Bear Stearns was acquired by JP Morgan 3 years ago. On May 7, 2011, The Atlantic reported that the SEC has now subpoenaed JP Morgan in connection with these allegations.

Chairman Shapiro, or perhaps you, Ms. Cross, without going into any sensitive information, what can you tell us about these allegations, about your investigation, or about your concerns about these abuses? And can you tell us what subpoenas—the subpoenas seek from JP Morgan?

Ms. SCHAPIRO. Congressman, as a matter of policy and fairness, we generally don't comment on specific ongoing enforcement matters. I can see if there is more information we can provide for the record that wouldn't jeopardize any ongoing investigation, and if that is possible, we'll provide that.

[The information referred to follows:]

[NOTE.—The information referred to was not provided to the committee.]

Mr. CUMMINGS. As an officer of the court, I understand.

I still think that this whole—you know, the reason why I raise these issues is because we must never forget what we just went through, are still going through. We must never forget our constituents who have suffered and continue to suffer, many of them having lost everything. And I just thank you again for the balance that you seek to—the balance that you bring to the table in seeking to address these issues.

With that, Mr. Chairman, I yield back.

Chairman ISSA. Thank the gentleman.

I recognize the member of the Financial Services Committee and subcommittee chairman here, the gentleman from North Carolina, Mr. McHenry.

Mr. MCHENRY. I thank you, Mr. Chairman. Ms. Schapiro, thank you for your service to our government. We appreciate you being back.

I do have a question. The SEC has a 499 shareholder cap. Can you explain what that is?

Ms. SCHAPIRO. Yes, I'd be happy to. One of the ways in which a company becomes a reporting company under the SEC's reporting regime—and there are five different ways—but one is if the company has total assets of more than $10 million and 500 record shareholders, you become a reporting company and you have to file an Exchange Act registration statement and then ongoing disclosure.

Mr. MCHENRY. Who are those investors limited to? What types of investors? Accredited investors? Institutional investors and employees, right?

Ms. SCHAPIRO. It's all investors. All investors in the company.

Mr. MCHENRY. No, no. Those that sought to, for instance, to invest in Facebook.

Ms. SCHAPIRO. Right.

Mr. MCHENRY. In order to be an accredited investor, you have to have a million dollars net worth, right?

Ms. SCHAPIRO. Yes.

Mr. MCHENRY. Or you have to be an institutional investor and an institutional investor is, what, $100 million in your fund; is that correct? OK. Or employees of the company, right? Those are the three classes of people that cap is—they can participate under that cap, correct?

Ms. SCHAPIRO. There may be other investors as well.

Ms. CROSS. The 500 number includes anyone who is an investor. There aren't any, under the current rules, that are excluded from the count. So employees count, accredited investors count, qualified institutional buyers count. That is one of the questions we would be looking at, whether we should count them.

Mr. MCHENRY. Right. So why 500?

Ms. SCHAPIRO. Five hundred was originally put in the statute in the 1960's, I think.

Mr. MCHENRY. My understanding was that this is not statute; that the SEC wrote this, right? Is that not the case?

Ms. SCHAPIRO. Correct me if I go wrong. It is in the statute, although we do have the authority to write rules that would change that. After the statute was passed, the Commission did write rules that went to how those 500 counted. So, for example, there may actually be thousands of investors under that 500 threshold, because we count holders of record. So if a broker-dealer is holding thousands and thousands, stock for thousands of institutional other customers, that counts as one because the broker dealer is the holder of record?

Mr. MCHENRY. So, why? Why 500?

Ms. SCHAPIRO. The view I believe at the time——

Mr. MCHENRY. What's the view now, because you have the authority to change it?

Ms. SCHAPIRO. It's an issue, obviously, that we are looking at very closely in our study. The view is that when a company has sufficient following—perhaps 500 is a bit of an arbitrary number—that those investors ought to have access to information on an ongoing basis about the company; that it has sufficient following that there ought to be public disclosure.

Mr. MCHENRY. OK. Really, you are talking about protecting people that have a million dollars' net worth, are institutional investors, or employees of the company. So the threshold's here. So it seems to me that the SEC policy is restricting access, because small businesses are the ones that we are really talking about here trying to access private capital with these investors. So it seems to me that really the SEC policy is that you are trying to protect the very people that this President says should pay more in taxes, higher taxes, or these sophisticated investors at the expense of small businesses accessing credit. Do you see it that way or not?

Ms. SCHAPIRO. Congressman, we see it as an absolutely legitimate thing for us to be inquiring about is whether that 500 number does continue to make sense; whether, as some have proposed, qualified institutional investors ought to be excluded from it; whether employees ought to be excluded from it. Although I will say, they are no less deserving of the protections of the securities laws than anybody else.

Mr. MCHENRY. My point is if you are a sophisticated institutional investor, I don't think the SEC is going to protect you from

Bernie Madoff, which clearly the SEC didn't do. And these folks are very sophisticated and know the decisions they're making. And for heaven's sakes, if you look at these substantial institutional players, to get better research and better information than the SEC or the Federal Government does.

Ms. SCHAPIRO. This is exactly the issue we are looking at. And of course they're not all sophisticated institutions. I take your point.

Mr. MCHENRY. You are talking about someone with a million dollar net worth as an accredited investor. Not only do you have to have a million dollar net worth, but then you have to be accredited, saying that you are sharp enough to do this stuff. It seems to me—I am sort of dismayed that the SEC didn't protect the grandmothers that had their life's savings taken from Bernie Madoff, but are trying to protect these people with a million-dollar net worth in the name of really starving small businesses from capital.

Ms. SCHAPIRO. Congressman, I would say we are receiving a wide range of proposals in this area. We are absolutely committed to looking at whether this threshold makes any sense; whether the threshold numbers for firms to stop reporting once they've been reporting, even though they may have thousands of shareholders, is are appropriate, too. And we intend to do a very thorough and rigorous analysis.

Mr. MCHENRY. Thank you. When do you think you'll have a decision?

Ms. SCHAPIRO. Well, we've got multiple work streams, as you can see from my testimony. This is the one work stream that is going to require economic data and analysis because we need to understand the characteristics of these companies and how they hold—their shareholders hold, whether in record name or in the name of the beneficial owner. And the staff has already begun to develop the work plan for this particular work stream. And I'd love to come back to you with a more concrete timeframe, but I can assure you that it is front and center on our agenda.

Chairman ISSA. The gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. I thank the chairman for yielding. Welcome, Chairwoman Shapiro.

We have heard repeatedly that the IPO market in the United States has declined significantly in recent years and I would like to examine this claim.

Experts from the SEC and the Federal Reserve analyzed a survey of 18,000 IPOs from 90 different countries between 1995 and 2007. And they issued a paper entitled Going Public Abroad. And the paper makes the conclusion and it says, "The U.S. domestic market has, by a wide margin, the largest proceeds of any of the markets worldwide." For example, the paper finds that the U.K. Saw a decline in the average proceeds generated by domestic and global IPOs during this period, but the United States did not. And the paper says that we did not in the United States see a significant change. And basically the paper says that we need to look beyond the number of IPOs and examine the question of the amount of revenue generated.

It looked at IPOs, 57 deals in the United States that raised over $27 billion in the fourth quarter of 2010, and further says that the United States achieved the highest IPO revenue total in the fourth quarter of 2010 since the fourth quarter of 1999.

So my question to you is basically on the fact that the article says, when excluding the 17 billion Visa IPO in 2008. Which was the largest, as you know, IPO in our country, the first quarter 2011 generated the highest first quarter proceeds since 2000.

So Chairman Shapiro, these indicators suggest that the U.S. IPOs are in their strongest in years. And I'd like the unanimous consent to put these papers in the record. And I'd like to ask you, Chairman Shapiro, whether or not you agree. Is this correct?

Chairman ISSA. Without objection, so ordered.

Ms. SCHAPIRO. I think there is no question that the IPO market is rebounding and we can see the numbers starting to change. And as you point out, the fourth quarter of 2010 we saw 60 IPOs, and this year, last year overall, we saw something like 153 percent increase. We are not back to historic levels, and there are lots of reasons for that. But we do have fewer small IPOs. We still have many very large IPOs, I think, that contribute to the number of many billions of dollars raised in the IPO market.

But I don't think there is any question but that we are starting to see this market come back, and you need only pick up the newspaper virtually every day now to see at least anecdotally evidence of that. But again our numbers would also bear out that this market is rebounding.

Mrs. MALONEY. And certainly we lead the world in volume.

Ms. SCHAPIRO. In dollars raised.

Mrs. MALONEY. I'd like to ask about the IPOs in the global marketplace.

And according to Ernst and Young that 60 percent of the global volume of IPOs in 2010 originated in so-called emerging markets. And I'd like to particularly look at activity in China. And China made the largest IPO ever in the financial sector with a 22 billion offering. But it was of a State-owned commercial bank, the Agricultural Bank of China, and Ernst and Young reported in their report that China's IPO and infrastructure and clean tech was boosted dramatically by government stimulus funding. You obviously have a huge IPO if the government is funding it.

And it goes on to point out that it far outweighed U.S. stimulus and that China spent over $586 billion in infrastructure and transportation projects and $735 billion in renewable energy. But as we know in our $778 billion stimulus package, it only had $48 billion in transportation and $16 billion in—$21 billion in renewable energy.

So my question to you, Madam Chairman, is how has the SEC analyzed the extent to which the IPO growth in China relates to extensive State spending?

Ms. SCHAPIRO. Congresswoman, we have not specifically looked at the issue of the extent to which governmental spending is influencing foreign IPO markets. I will say that generally we are seeing much more mature markets abroad than we have historically, making them more hospitable and more credible places for companies to do IPOs that might have years ago come to the U.S. market.

Mrs. MALONEY. The Renaissance Capital Research wrote in an article entitled "U.S. IPOs on Top of Game," and this article finds there's been a lack of U.S.-listed Chinese IPOs because U.S. investors have balked at the poor quality of IPOs in China.

Chairman ISSA. The gentlelady's time has expired.

Mrs. MALONEY. Can I just throw one little question to her?

Chairman ISSA. If you can be very brief.

Mrs. MALONEY. Does the SEC find that foreign markets may not impose the same high standards imposed on U.S. firms issuing IPOs domestically?

Ms. SCHAPIRO. One of the interesting phenomenons—and I know Mr. McHenry is very interested in this as well—is this phenomenon of companies that are not necessarily incorporated in China but have a large part of their operations in China actually doing reverse mergers as opposed to IPOs, and coming into the U.S. market to list on U.S. exchanges. And there are a number of issues there about which we are quite concerned and working through with the Chinese regulators.

Chairman ISSA. The gentleman from South Carolina, Mr. Gowdy.

Mr. GOWDY. Thank you, Mr. Chairman.

Welcome, Madam Chairwoman. Is the general solicitation ban constitutional, and can you cite me to specific published opinions that support your opinion?

Ms. SCHAPIRO. Congressman, I think that you raise a very good question with respect to the general solicitation ban, and the chairman has raised that as well in some of his correspondence. And we absolutely recognize that the general solicitation ban does limit speech to some extent, so it's one of the issues we are looking at in our study. And a First Amendment analysis will be part of that.

I think the issue for us is whether the general solicitation ban passes First Amendment amendment muster, but in addition, whether it's protection of investors is appropriately balanced with the needs for companies to effectively communicate in order to raise capital. And so that is one of the issues that we will be looking at closely.

Mr. GOWDY. Well, given the fact that it implicates a fundamental right, you have the strictest level of constitutional scrutiny and it has to be as narrowly drawn as it possibly can be. If you conclude in your own independent analysis that it is not constitutional, will you do what there is some precedent in the executive branch for doing, which is not enforcing laws that you don't think are constitutional? Will you abandon the ban if you conclude that it doesn't pass constitutional muster?

Ms. SCHAPIRO. I believe I obviously can't predict where we will come out on this issue, but we would—rather than not enforce a law that is not on the books, we would seek to change it.

Mr. GOWDY. There is some precedent for not enforcing laws that are not on the books. I think you would agree with me.

Ms. SCHAPIRO. There is precedent. But I have a sworn duty to uphold the law and the Constitution, and so I would be a bit uncomfortable with just ignoring a provision of the law. But that said, this is an area we will be looking at very carefully.

Mr. GOWDY. With respect to 2008, do you know or can you tell me the number of defendants who received active prison sentences—not fines, not promises not to do it again—but active prison sentences?

Ms. SCHAPIRO. I really can't speak—we don't have criminal authority and we don't prosecute cases in the criminal justice system. I can tell you that for the Securities and Exchange Commission, we brought more than 670 cases with disgorgement of ill-gotten gains and penalties that were ordered of over a billion dollars, and a billion dollars returned to investors who had been harmed by securities fraud.

Mr. GOWDY. And those are very big, laudable numbers. Of those cases, how many did you refer for criminal prosecution to a respective U.S. attorney's office?

Ms. SCHAPIRO. I would guess a healthy number, and I'd be happy to provide that exact number to you.

[The information referred to follows:]

[NOTE.—The information referred to was not provided to the committee.]

Mr. GOWDY. I would be interested because I am asked quite often in South Carolina why nobody goes to jail if you are rich, and all you do is steal money and you don't go to jail. I am very interested. And I am also interested in whether or not the SEC would have appeared and asked for an enhanced sentence or an upward departure given the erosion of public trust that was manifested in 2008.

Ms. SCHAPIRO. Congressman, I think if you look at the sanctions that the SEC has leveled over the past several years for violations, again civil violations of the Federal securities laws, you will see that they have ramped up rather significantly. I gave you the number of 2008, but in 2010 our disgorgement of ill-gotten gains and penalties reached $2.85 billion and we returned $2 billion to harmed investors.

Mr. GOWDY. I am not giving short shrift to your disgorgement. That is wonderful. But you can criminally prosecute and disgorge someone of their ill-gotten gains at the same time. And nothing gets people's attention quite like an active sentence.

Ms. SCHAPIRO. There is no question about that. And we make many referrals to the Justice Department. And we bring many cases jointly with local U.S. attorneys and district attorneys around the country and try to interest them in bringing more securities fraud cases whenever we can.

Mr. GOWDY. Ma'am, would you be gracious enough to get me—obviously, I don't want pending investigations, but cases that are concluded that were referred to various U.S. attorneys offices and what the outcome was?

Ms. SCHAPIRO. I'd be happy to.

[The information referred to follows:]

[NOTE.—The information referred to was not provided to the committee.]

Chairman ISSA. Will the gentleman yield?

Mr. GOWDY. Yes, sir.

Chairman ISSA. Madam Chair, just one quick question. I know you can't always answer hypotheticals. But as you're aware, we allow, and have for a decade or more allowed prescription drugs of all classes, but we will just take, for example, sleeping aids that are prescription-only to be advertised with a basically a "must see a doctor" to get the appropriate advice.

In a sense, as Mr. Gowdy said, if there is an inherent bias toward free speech, isn't it most likely that you're going to end up looking at that model and saying, Wait a second. If we limit the purchase of these companies to qualified investors, other, you know, institutions and so on, if we are limiting who can buy, if any advertising were to explain that you cannot buy it unless you fit in this category, what would be the harm any more in a general solicitation than there is in making people aware about a prescription drug, knowing that they must go to a doctor before they can have it prescribed?

Ms. SCHAPIRO. I think you raise exactly the right issue. I will say there is a concern that the general solicitation ban is designed to make it more difficult for those who would defraud others by casting a very wide net even in the private placement market and have an easier way to defraud people because of the general solicitation, the general advertisement, the way to bring more people into a fraudulent scheme. That said, as you know, we are going to look at this very carefully.

Chairman ISSA. I recognize the gentleman from New York, Mr. Towns, for 5 minutes.

Mr. TOWNS. Thank you very much. Thank you and the ranking member for holding this hearing and let me thank you, Chairman Shapiro, for the outstanding job that you're doing.

In your written statement, you indicated that 22 percent of the SEC cases in fiscal year 2010 were offering fraud. Chairman Shapiro, can you give us an example of an offering fraud?

Ms. SCHAPIRO. I would be happy to. And I will say that every Thursday, the Commission meets in a closed session to consider a dozen or more enforcement cases. And so it's very much on my mind as we go through this process to ensure that we don't lose sight of—even though I think there's flexibility, there are things we need to look at, there are maybe things that we can do quite differently—we do not lose sight of the fact that there are investors who need the protections provided by the Federal securities laws.

But what we see are offerings by promoters or others of stock in a company where the disclosure has been false or misleading, the information has been manufactured, where there are unregistered offerings and they're sold to people who are not accredited investors or who are appropriately qualified to buy that particular offering.

Ms. CROSS. Another type we see significant numbers are affinity frauds where they target particular categories of people like the elderly. So you see a broad range. It is not the kinds of companies that we all think of as appropriately using our exemptions, but they drive through those exemptions and go after people who are not able to fend for themselves.

One of the things that worries me a great deal as we look at the question of loosening the ban, which I think is a very important thing to consider, is how we then make sure that the people who buy really are the accredited investors who don't need the protections, because they do target those people. The fraudsters do target those people.

Mr. TOWNS. If they go in court, what is the effect of these frauds on investments and the market if they go in court?

Ms. SCHAPIRO. The frauds can be devastating to investors, and that is true really of any kind of securities fraud, that people have been convinced in many of these schemes to invest their life savings and are left with nothing at the end of the process.

Mr. TOWNS. Chairman Shapiro, what are some of the examples of some of the things that the SEC has done to facilitate communications connected with public offerings?

Ms. SCHAPIRO. Congressman, over the years, the SEC has engaged in a number of efforts to make it increasingly possible for companies to communicate during the quiet period, which is when they are generally not communicating. For example, we've created a research report safe harbor to encourage the publication of research reports during the quiet period. We allow free-riding prospectuses which permit offers outside the statutory prospective. We allow the media to publish stories about companies or their registered offerings, so long as the media is unpaid or not affiliated with the issuer. We have done a number of offerings related communication safe harbors, again, that allow issuers to communicate more details about transactions to potential investors during the quiet period.

So we've taken a number of steps, primarily starting in 2005, to try to relax some of the restrictions on issuers during the quiet period.

Mr. TOWNS. Thank you. Do you give—do you view the general solicitation ban as an impediment for capital raising for small businesses?

Ms. SCHAPIRO. We have heard from some small businesses that the general solicitation ban makes it harder for them to reach investors and to raise capital. That is one of the things that we will be looking at as we do our study of the general solicitation ban. We want to understand the extent to which it is an impediment or an unnecessary hurdle to capital formation.

Mr. TOWNS. Thank you very much.

Mr. CUMMINGS. Will the gentleman yield?

Mr. TOWNS. I'd be delighted to yield to the ranking member.

Mr. CUMMINGS. Just following up on what you just said. When you go into trying to figure that out, whether it's harming and folks—I mean, what kind of factors would you likely be looking at? I am not trying to get into your head for you to tell us everything you're going to do. What kinds of things will you be looking at to come up with a reasonable answer to that?

Ms. SCHAPIRO. I think with respect to that point in particular, we will probably do interviews with businesses that are pre-IPO businesses or their advisers. We'll also ask investors and the general public. We might put out a concept release and seek information and detail that way, and hopefully we will use our new Advisory Committee on Small Business Activities.

We have multiple areas we want to explore here. And there will be different approaches for each one. For example, with respect to the 500 shareholder threshold, there we want data and analysis of the characteristics of these companies—which will be hard to get, because they're private companies—and understand how their stock, how their holders hold their securities, whether they hold them in street name or in direct name or so forth.

So for each of the work streams that we are going to be exploring, we've started to lay out the data and the information we think will be most useful for us in trying to strike that appropriate balance.

Chairman ISSA. The gentleman from Arizona, Mr. Gosar.

Mr. GOSAR. Thank you, Mr. Chairman.

Let me ask you a question. How many regulations are there out there, that a small company that wants to go public, that they have to apply to? How many apply?

Ms. CROSS. I can try with that. For a company that is going to conduct an IPO, there is a registration form, form S–1, that is the main place they have to look. And then there is a series of regulations that govern what you're allowed to do in the way of communications in the offering. So there's probably, I would say, in the SEC's books probably 50 rules, something around like that. We could certainly supplement for the record.

It's a pretty tried and true path. So for the companies that go through an IPO, the advisers to them—I used to do this before I came to work at the SEC. There is a pretty clear path. There is a handbook that people hand out to their companies as they're thinking about going public. So it's not as daunting as you might think.

Mr. GOSAR. So you would say it's adequate if there's not too many, not too few?

Ms. CROSS. I think that the balance is manageable. I think there are definitely a lot of rules. But the goal here is to make sure that as companies are accessing the public markets for money, that they—that investors are protected enough so that they feel confident going in and investing.

Mr. GOSAR. And are they nimble with the times?

Ms. CROSS. I think that we can certainly think about that. We revised the offering rules very significantly in 2005. It was called securities offering reform and it was a huge overhaul. It's what, for the first time, let companies have free writing prospectuses, let them keep talking during quiet periods, let them have electronic road shows on line. So it was a pretty big change. And I think it has really helped. That doesn't mean we can't do more to help. So we always are looking at our rules to see whether we're doing what we can to facilitate capital formation consistent with investor protection.

Mr. GOSAR. So when you are looking at fraud, going back to Mr. Gowdy here, being a dentist and bringing a private sector aspect and looking at the regulations of the State, when there's an IPO that's foreign-based versus a U.S. predominately based, do you see a problem or predilection within those groups of where you have to have more enforcement?

Ms. CROSS. I'm sorry, sir.

Mr. GOSAR. Taking an IPO that is foreign-based predominately versus an IPO that is U.S. based predominately, do you see much more enforcement issues from one of those segments?

Ms. SCHAPIRO. I guess I would say that I think it depends on what markets you're looking at. There's quite a range of requirements around the world with respect to the process of accessing the public markets. I mean there's no question but that the SEC in the United States has one of the best developed enforcement programs and polices the markets—we think there's always more to do—but pretty effectively. But I think other markets now are stepping up and doing very much the same thing because what they understand is that to be a credible location for an IPO, and for people to feel comfortable investing in new companies, there has to be a credible enforcement regime around that so that fraud is stopped and people can have confidence in the integrity of the financial statements and the disclosures that the companies are making. So I actually think there's kind of a rising tide around the world in this regard.

Mr. GOSAR. I'm worried more about right here in the United States. Do you see more a problem with IPOs that are predominately foreign based or U.S. based?

Ms. SCHAPIRO. I'm sorry, I misunderstood your question but clearly we've had some issues recently and you, I'm sure, read about them in the paper with respect to reverse mergers of companies whose primary operations are in China, although they may not be registered and generally they aren't registered in China and they aren't subject to the jurisdiction of the Chinese SEC, and our ability to deal with the disclosure shortcomings of some of those companies. So we have had a very active program at the SEC, including suspending—revoking the registrations of eight Chinese companies in the last month or so and suspending the trading in just the last couple of weeks of three more of those.

I had the opportunity yesterday to meet with the chairman of the China Securities Regulatory Commission and talk about how we can establish a framework for our enforcement and examination staff to have better access to information about these companies who are not incorporated in China but whose primary operations are in China and whose auditors are in China, so we can understand the quality and the truthfulness of their disclosures.

Mr. GOSAR. One more real quick question. Is there one part of the marketplace for these particular investments? I'm looking at medical devices that are having some problems in which there are public offerings. Do you see any recourse or any aspect so that you're looking at one segment of the population of investors?

Ms. SCHAPIRO. It's been interesting to me over the years to see that we often have fraud in whatever industry is hottest at the moment. So a number of our actions with respect to these companies with operations in China have been in the energy space, but they can be in whatever they think investors will be most taken with at that particular moment.

Mr. GOSAR. Thank you.

Chairman ISSA. I thank the gentleman and if the chairwoman can allow a couple of minutes for the gentlelady from the District of Columbia, who has been waiting here patiently, you're recognized for up to 5 minutes based on her time.

Ms. NORTON. Thank you very much, Mr. Chairman. I thank you for your indulgence and welcome Chairwoman Schapiro. You have a very tough, you always have a tough job particularly after the extraordinary crash after 2008. You had to somehow encourage continued investment without getting us back into the terrible hole we were trying to get out of. Now, you can have an ideological notion of cause and effect that says the government caused, government regulation, for example, caused this or its opposite, that the failure of regulation caused this. But whatever is your notion, and I hope we're not into that kind of catechism of cause and effect, I'd like to have you discuss the effect on investors.

I have some figures here that showed some remarkable actions, which I think was very rational behavior, that investors pulled more than $272 billion out of the stock market, and it looks as if when they went to invest they invested in the bond market which they regarded as more, as safer, $272 billion out, $650 billion into bond funds. And then if you look at the middle class, 70 percent of the money in the 401(k)'s were taken out, the proportion failed or lost, proportion then fell to 49 percent. And it's back up to 57 percent.

So, I would like you to discuss the effect that this collapse had on investor confidence and how it affected the availability of capital. In other words, if people were not putting their money in the stock market, what was the effect on the availability of capital?

Ms. SCHAPIRO. Congresswoman, I think, and I believe this very deeply, that the foundation of our markets is absolutely built on investor confidence, and we can see how portable capital is and how quickly investors will react to what they perceive to be failures in the marketplace because of fraud, because of inadequate information, and an issue I'm most particularly familiar with is what happened after May 6th when our equity markets performed in a very aberrational way as a result of market structure flaws and high frequency trading, and we saw for months and months after that a steady outflow of investor funds from equity mutual funds because of concern about the integrity of the trading mechanism in the marketplace. So I think for us, instilling and restoring investor confidence in the integrity of our markets, whether it's the disclosure regime or the market structure itself is really paramount to the ability of companies to do IPOs and raise capital and create jobs and grow our economy which is, at the end of the day, what all of us want to see happen.

And for us that means getting this balance right between protecting investors and making access to capital affordable and efficient, is really sort of job one right now for us to strike that balance appropriately.

Ms. NORTON. So the collapse then decreased the ability of firms to access the capital markets and to raise money on the stock exchanges?

Ms. SCHAPIRO. Yes.

Ms. NORTON. There are some who suggest that if you rolled back the investor protections that the impact would be some of the, some of what we see on this chart would be alleviated. What do you think would be the impact on the confidence of American investors if you were to roll back or we were to roll back the investor protections that have recently been instituted or established?

Ms. SCHAPIRO. Well, while I think it is very worthwhile or for us to look at whether our rules can be altered and tweaked in a way that facilitates capital formation and doesn't harm investor protection, I think a complete rollback of investor protections wouldn't serve anybody's interest, not investors nor companies.

Ms. NORTON. How much of a rollback?

Mr. MCHENRY [presiding]. The gentlelady's time has expired. If you could finish answering the question. I also know you have a hard stop time of 5 minutes ago.

Ms. SCHAPIRO. I do. Thank you. It is not a question that can be answered in generalities. I think it's really a matter of looking at each and every one of our rules to see where there might be flexibility that will facilitate capital formation without doing harm to the investor protections, because at the end of the day those protections serve the companies well, as well as investors.

Mr. MCHENRY. The gentlelady's time has expired.

Chairman Schapiro, thank you for appearing before the committee and thank you for your time, and we certainly hope that you can make it to your next appointment in time. And with that, 5 minutes for Mr. Lankford from Oklahoma.

Mr. LANKFORD. Thank you, Mr. Chairman. And thank you, Chairman Schapiro, for being able to be here. We appreciate your time. I completely understand.

We're going to talk to you a little bit of the XBRL language shift that's happened a little bit and I want to get a chance to talk a little bit about that 2009 SEC sort of collecting the financial statements using that XBRL language and the plain text. Can you update us on the efforts and in that transition how is that going at this point? Where are we in that shift?

Ms. CROSS. I appreciate your question. The XBRL requirements are being rolled out over time based on the original adoption schedule. So the next phase of companies is the smallest companies have to start tagging and XBRL the face of their financials and I think they have to block tag footnotes, and the rest of the larger companies will be doing the detail tagging of their footnotes I believe starting at for quarters ending after June 15th. So it is in the works.

Mr. LANKFORD. How is that going as far as the rollout? What has been the response back from companies on that?

Ms. CROSS. I think, I will admit, it's mixed. Some companies are very concerned about the additional time that it takes and so we hear that they would like there to be, for example, a time delay between when they have to get the XBRL on file compared to when the 10Q, for example, the quarterly report, is due, which is a question we've been thinking about. We've also been hearing that there are concerns in the smaller business community about the possible costs of taking on this new requirement in June, but at the same time I would say that the usefulness of the information is starting to become more apparent, so recently our staff was able to do some really good analysis based on using the tagged information, and I was really pleased with what you could do comparing, for example, pension fund rates of return being assumed in the financial statement. So that it's a new cost and it's a new burden, but it's also useful information.

Mr. LANKFORD. How is that going as far as the fraud and capturing that, what we were just talking about as well from the SEC side? Is it fulfilling what we had hoped it would fulfill?

Ms. CROSS. I think it's too early to tell. The amounts are just now starting to show up in the financial statements and we're just now getting the tools to use it because the key here is that you have to be able to use it and we've had to spend the money to be able to buy the tools to use the data so we're not at that point yet, but it is helping us issue better comments on the filings of companies when we see aberrational amounts that show up because of the XBRL.

Mr. LANKFORD. Are we picking it up faster? I know it has to be faster than pen, paper reading through it on plain text and going through it with a pencil.

Ms. CROSS. You need both.

Mr. LANKFORD. So perpetually we're going to have both the plain text version and the XBRL version you think as far as submitting it?

Ms. CROSS. I think it's going to depend a lot on how the markets and the investing public develops because unless the public can use XBRL we need the plain text because the information at the end of the day is for them, not for us.

Mr. LANKFORD. Let me ask you on a couple of things, where are we as far as timeline on the fiduciary rules? That has been a topic of obvious conversation in trying to figure out when are these fiduciary rules going to come down dealing with the brokers and CFEs and all that. How is that all going to balance out? Not necessarily what the decision is, that's not what I'm asking. When is the timeline for that decision?

Ms. CROSS. I apologize. I'll have to get back to you with an answer for the record. That's not in my, Corporation Finance Division, so with Chairman Schapiro not here I don't know the answer. I believe that it's not right now, but——

Mr. LANKFORD. That part I knew.

Ms. CROSS. So you know more than me. I'm sorry. I will have to get back to you with the answer for the record.

[The information referred to follows:]

[NOTE.—The information referred to was not provided to the committee.]

Mr. LANKFORD. We will try to followup on that on the record just to get a feeling on that.

Going back to some of the other information, the prospectus and such, as it comes out, give me a feel. There is somewhat a sense that we can solve a problem dealing with fraud based on adding more text to someone at the beginning. If you go to a typical constructionsite right now, there are 28 different posters up on the wall in the constructionsite defining out all the issues that are there. If you're going to get a home mortgage, be prepared for reams and reams of paperwork that are going to be involved in that. The prospectus is rather long for a lot of things.

Is that fulfilling what we hope it would fulfill by continuing to add additional text to different prospectuses to get more information out to it or has it hit a point where no one is going to read it because it's so protracted now?

Ms. CROSS. I think that's an excellent question, and in fact one of the projects that I have wanted to undertake is a review of all the disclosure requirements to see if there are some we could actually get rid of.

Mr. LANKFORD. That would be very helpful.

Ms. CROSS. Because there is a pile-on effect. So I agree that there can be too much. Investors and analysts in particular tend to want more information and so to take some away can take some doing. But we, I think it's very important that we take a look, and I agree with you that we need to be careful to not just pile on.

Mr. LANKFORD. Thank you. That would be very helpful. Thank you. With that, I yield back.

Mr. MCHENRY. Mr. Tierney is recognized for 5 minutes.

Mr. TIERNEY. I thank the chair. Thank you, Ms. Cross, for being here today. I don't have a lot of questioning for you. I just wanted to touch on Sarbanes-Oxley a little bit. In that Section 404 that requires that an auditor attest to the entity's internal financial controls. I know there's been some discussion the first $75 million is exempted out, companies over 75 million are in, some people want to raise it to $250 million.

I would like to have your opinion on the effectiveness of the— first of all, the burden on $75 million as opposed to $250 and whether or not it's outweighed by the benefits on that and just what the benefits are.

Ms. CROSS. I appreciate the question. As you know, in Dodd-Frank, in the Dodd-Frank Act the companies below $75 million public float were exempted from the audit requirement under 404(b). That actually takes out of the mix 60 percent of the public companies, which is quite a significant number. The staff just posted its study, as required by the act, of the companies between $75 and $250 and found several important characteristics of those companies, one of which is that the companies in that category tend to change a lot. So companies in the $75 to $250 may not be the same year after year. So changing the application of 404 to that group is very complicated and doesn't really help them very much because they would be moving in and out.

We also found that the companies in that category don't tend to be particularly different from the companies above 250. So it's not a discrete category that has characteristics that lend itself to saying, well, this is the group that should be out, and the benefit of the audit, certainly it costs money, the costs have come way down over the years with the addition of the AS 5, the auditing standard that brought down the cost of that audit. But I think that the staff's conclusion was that the benefits of having that second set of eyes at that, at this point outweighed the costs of the audit.

Mr. TIERNEY. Ironically, I think one of the findings for the chief accountant was that when they attested the accuracy of financial statements, they're more accurate. It's pretty common sense, but they are finding out that is the case.

Ms. CROSS. That's correct. Where there's going to be a second set of eyes, I guess people are a bit more careful.

Mr. TIERNEY. What do you think the consequence of eliminating the safeguards of Sarbanes-Oxley in that respect would be?

Ms. CROSS. I'm sorry, eliminating the——

Mr. TIERNEY. The 404(b) provision.

Ms. CROSS. I think that there would be a significant concern that the care taken in establishing and testing the internal controls would go down over time. Not having that second set of eyes I think is important.

The other thing is that if you don't have the internal controls audit, then the auditors have to do testing of the internal controls to see how much they can rely on the financial statements even without the audit of the internal controls. So the costs don't necessarily correlate one for one.

Mr. TIERNEY. Well, thank you for being with us this morning, Ms. Cross. I yield back.

Mr. MCHENRY. And with that, Mr. Meehan is recognized for 5 minutes.

Mr. MEEHAN. Thank you, Mr. Chairman.

Thank you, Ms. Cross, for being here today.

I want to step off on an issue that was raised by my partner to the left, China and the discussion of fraud that enters our marketplace. As we get into increasing globalization and more people come to raise capital in the United States but have significant assets and operations overseas, what kind of protections do we have in place to assure that if there is a remedy that needs to be reached that we can get at assets or individuals or otherwise that are operating in these foreign countries?

Ms. CROSS. That's a very good question, Congressman. We don't have the same remedies that we do here. And the way the securities laws are structured, we deal with that through disclosure. We let companies warn investors that they won't have the same remedies if there's a problem with the company.

We don't—the SEC doesn't have a merit regulation screen. We don't have authority to tell companies you can't raise money here if you provide sufficient disclosure.

What we've tried to do, though, to provide as much investor protection as we can in light of these concerns is, for example, Chairman Schapiro met yesterday with the head of the Chinese Securities Regulatory Commission to discuss better ways for us to share information to get at our concerns about are these companies for real? Who are their promoters? And we have a new initiative to get a better sense of how are the audits being done. You do have to have an audit. And so are we appropriately regulating those auditors? Are they going over and looking at these companies or are they doing it remotely with people on contract? That would be a concern. These are all issues that we recognize are very important that we get on and so we're doing the best we can.

Mr. MEEHAN. That's right. It's not just, it's not just those auditors. It's also the ability for sort of the independent analysts that come. There's already a shortage of the kind of analysis that we like to be seeing on the market now. I think there's been a shrinking of the banking institutions and otherwise commitment to do an analysis.

Are we getting the kind of cooperation to allow analysts to travel to the foreign countries and be given complete access to the information that companies here would be giving to analysts?

Ms. CROSS. That's a fair question. I don't know the answer to that. I think we would be happy to check and get back to you for the record.

[The information referred to follows:]

[NOTE.—The information referred to was not provided to the committee.]

Mr. MEEHAN. Let me switch my questioning just on the issue of the cap of the 500. One of the concerns that I have is in this environment we're seeing a great deal of frustration on the part of entrepreneurs who are trying to raise capital in difficult times. Obviously one of the things they are looking for is access to the markets.

One of the things that inspires people to continue to work in sort of startup companies is the idea that they can take and gain some equity stake by being given shares in the company. Are we doing anything or can you talk a little bit about what kind of incentives we can give to carve out the counting of that 500 for individuals who are sweat equity holders in these startup companies?

Ms. CROSS. That's an excellent point. And I appreciate that is a key way that they can incentivize employees to come work for them and work hard.

We have done a few things. First off, the options that are granted to employees don't count against the 500. So we adopted a rule in 2007 that said you don't have to count the options. We have, the staff in my division has provided relief also to companies that they don't have to count restricted stock units that are provided to employees.

So far, you still have to count stock. They're stockholders like anyone else. Our review that we're getting ready to undertake of Section 12(g)'s 500 limit will consider the question of should employees be counted the same way.

There are concerns. There are certainly frauds that happen where employees are the ones who lose both their job and their investment. So you do want to watch out. You don't want employees to lose everything when there's a fraud at the company they work for. So we need to balance those.

Mr. MEEHAN. My concern as well as the inability—or the ability that has to crowd out the ability for, it sort of limits the pool of people as well, the 500 that allows us to raise money if in fact you are including those kinds of shareholders in your number, then it makes a smaller pool that effectively you can raise your dollars from which presumably then sort of has—would you agree that has a chilling effect then on the ability? Because I would think that it would cause the cost of that capital to increase for a small business trying to attract investors.

Ms. CROSS. We have heard that the 500 cap is an impediment to capital raising. And the question we need to look at is 500 the right number? And are we counting correctly? Because there's a lot of companies that are actually private companies that trade in the OTC markets that have thousands of holders. But they are held in street name and so they only count by broker. And so we need to look at how are we counting and is the number the right number and are the right people included in the count? So there's a whole lot of good hard questions we need to know the answers to.

Mr. MEEHAN. Thank you, Ms. Cross. I yield back.

Mr. MCHENRY. The gentleman's time has expired.

Mr. Connolly for 5 minutes.

Mr. CONNOLLY. Thank you, Mr. Chairman.

Welcome, Ms. Cross.

Ms. CROSS. Thank you.

Mr. CONNOLLY. Ms. Cross, between 1990 and 2000, or between the 1990's and the 2000's, did SEC issue new regulations affecting IPOs?

Ms. CROSS. Not—I don't believe so.

Mr. CONNOLLY. You did not issue new regulations affecting IPOs; that is what you just said?

Ms. CROSS. In that timeframe I'm not aware that we had significant new regulations——

Mr. CONNOLLY. Right. And yet we are supposed to buy into an argument that it was this stifling new regulations or regulatory environment that, in fact, choked off IPO activity?

So if one were to conclude that, well, you can't cite new regulations in that time period, one wonders what it might be.

Are you familiar with David Weild?

Ms. CROSS. That's a study?

Mr. CONNOLLY. Former vice chairman of NASDAQ?

Ms. CROSS. Oh, yes. Yes.

Mr. CONNOLLY. He wrote a paper called "Market Structure is Causing the IPO Crisis" in June of last year, co-authored with Edward Kim. He writes, the crisis started before Sarbanes-Oxley in 2002. The IPO crisis was not induced by Sarbanes-Oxley, regulations, fair disclosure or NSD Rule 2711, separation of banking and research. Each of these changes occurred well after the IPO crisis was underway.

That's what he writes. Would you agree with that assessment.

Ms. CROSS. I think there's a whole host of reasons why IPOs are fewer than they were before, and I think that, I appreciate that different people attribute it to different reasons. I think that certainly the market structure has changed. There used to be a lot of smaller investment banks who did the small IPOs and those small investment banks are mostly gone.

There used to be research written about little tiny companies, but the structure of the investment banking industry no longer supports research about little tiny companies. And so the little tiny companies are the ones that are not tapping the public market, and I'm sure cost of regulation is one factor in that. But I also think that the market structure changes are also quite important.

Mr. CONNOLLY. Well, he seems, the former vice chairman of NASDAQ, hardly a gung-ho regulator, he seems to believe that this IPO crisis predates whatever new regulation occurred post Sarbanes-Oxley, Sarbanes-Oxley and subsequently, and then as a matter of fact it can be attributed to a dysfunctional IPO market itself, that it's a failure of the market itself in terms of what happened with arbitrage and what happened in terms of where capital went, sort of switching from productivity-oriented investment opportunities to sort of quick turnaround investment opportunities and you see that reflected in the broad market.

Would you think that's a fair observation on his part.

Ms. CROSS. Well, I'm not the expert he is, but I would say that those are certainly observations that I've heard that many agree with.

Mr. CONNOLLY. Would there be consequences in your view if we sort of had a broad brush elimination of regulations currently governing the IPO market?

Ms. CROSS. Yes, I think there would be very significant negative consequences if that were to occur because then you wouldn't have sort of a level set of minimum investor protections that could be expected as a company enters the public market seeking money. So I think that there would be significant adverse consequences both to the public and to the companies because those that are good and honest would be harmed by the bad actors who would cause investor confidence to wane, and investor confidence is key to having a robust capital market.

Mr. CONNOLLY. And have there been some bad actors?

Ms. CROSS. Yes.

Mr. CONNOLLY. Oh. Against whom the public needs to be protected?

Ms. CROSS. That's right. Yes.

Mr. CONNOLLY. So it's more than caveat emptor. Maybe the Federal Government has a role here to try to protect the consuming public and the investing public?

Ms. CROSS. Absolutely, yes. We have to calibrate the regulatory environment and the ability to raise capital and get it right, and that's a very challenging task that we try very hard to do.

Mr. CONNOLLY. Thank you. My time is up.

Mr. MCHENRY. Ms. Buerkle for 5 minutes.

Ms. BUERKLE. Thank you, Mr. Chairman. I have no questions. Thank you.

Mr. MCHENRY. Will the gentlelady yield?

Ms. BUERKLE. Absolutely. Thank you.

Mr. MCHENRY. I certainly appreciate her yielding. And Ms. Cross, in terms of independent financial statements, having, ensuring that there is independent audits of firms, do you think that is proper and good procedure?

Ms. CROSS. Definitely yes, that's important.

Mr. MCHENRY. I know it's an easy question but, and that gives the investors some assurance of the legitimacy of the financial statements?

Ms. CROSS. Yes. It does.

Mr. MCHENRY. So in terms of that step of the process, then the question about accredited investors, why is there this class of accredited investors? Why is that important in the SEC's view?

Ms. CROSS. Well, the notion of a accredited investors is, to be clear, there's no special accreditation. If you have $1 million net worth, then you fit in the definition. If you make $200,000 a year, you fit in the definition.

Mr. MCHENRY. Why is that important?

Ms. CROSS. Those are the investors that—this test was put in in the early 80's and in the early 80's it was determined that those are investors who could fend for themselves and didn't need the protections of the securities laws and so they could participate in unregistered private offerings.

Mr. MCHENRY. So why limit that number if those, if that class of people doesn't need the level of protection that you are seeking for me as an average investor?

Ms. CROSS. You mean in connection with the 500 holder limit?

Mr. MCHENRY. Yes.

Ms. CROSS. I think it's a fair question. I think that the, I will say that since the number was set in the early 80's one might question whether that is still the right number to identify the people who can fend for themselves. But assume that it is, then when Congress put in its test in the early sixties for the 500, did they have in mind that those were companies that were trading and did they, for example, you don't—you have to register if you are trading on the New York Stock Exchange, it doesn't matter if your investors are accredited or not. So it's a different test. If securities are trading in our markets, do we want a certain level of information available? But it's a fair question for a company that's not trading in a market today, should we eliminate some number of investors from that count, whether they be accredited or qualified institutional investors or some other group? And it is absolutely something we want to consider.

Mr. MCHENRY. OK. And that's part of the process that you are reviewing right now?

Ms. CROSS. Absolutely. Absolutely.

Mr. MCHENRY. Because I think everybody has this question, what is the proper balance?

Now in terms of general solicitation. I know there's been an enormous discussion because of what we saw with FaceBook, that in essence out of concern that it was a public solicitation because word got out of this private offering of FaceBook stock, that meant that they could not offer those securities to American investors. So they offered it to foreign investors.

Now I understand there are regs on the books, but there is also litigation associated with that, is there not? A significant amount of litigation on what qualifies as general solicitation?

Ms. CROSS. I think there is some case law about it. Just to be clear, as we said in the letter that Chairman Schapiro sent to Chairman Issa, the staff did not tell Goldman Sachs and FaceBook that they couldn't conduct their offering in the United States and in fact there is some SEC guidance that would have actually suggested they could.

They may have decided not to conduct the offering here because of concerns about private parties asserting that they had a rescission right because of potential public offering. So if that is what your question is about.

Mr. MCHENRY. Is there a review currently about general solicitation and those rules?

Ms. CROSS. Yes, that is definitely. That's one of our workstreams is to consider whether the ban on general solicitation is still appropriate in this day and age.

Mr. MCHENRY. OK. And what do you think your timeframe is there?

Ms. CROSS. On that particular workstream, that is less complex than the 12(g) 500 holder workstream. So we've started already to put together the research that needs to be done. I think my likely recommendation would be for the Commission to issue some sort of what's called a concept release where we put out the general question of it, does the public think this is a good idea? What dangers would it cause? So that's, I can't commit to a specific timeframe but it's certainly shorter than the 12(g).

Mr. MCHENRY. Next year? Within the next year?

Ms. CROSS. I think certainly the process will start in this year, and then we'll get the feedback.

Mr. MCHENRY. Thank you. And thank you for your candor. With that, Mr. Cooper is recognized for 5 minutes.

Mr. COOPER. Thank you, Mr. Chairman. I have no questions, but I would be delighted to yield my time to my friend and colleague, Mr. Cummings.

Mr. CUMMINGS. Thank you very much. Let me just go back to something I had asked Chairwoman Schapiro about. And I was, I had asked her about when you gather all the information, what are the kinds of things that you will be looking at to strike the balance?

She told me where the information would be coming from but didn't get into what kind of things you're trying to—what goes into that process of striking a balance? We've had a wonderful discussion here about the problems and what have you. But I'm trying to figure out when you sit down at the table, are there certain principles that may be guiding, guiding principles so that you can have a way of weighing what you're doing so that you come out with—and I'm not asking you for your final solution, I'm just trying to figure out what are the kinds of things that you think, that you think that you all would be looking at. I'm mainly concerned about again those guiding kind of principles.

Ms. CROSS. That's an excellent question, Congressman. I think that the—starting, for example, with the ban on general solicitation, if we eliminate the ban so that offerings, private offerings could be made to accredited investors through publicity, through advertising and the like, I would want to know whether we're confident that the group that's getting sold to is the group that doesn't need protection and that the people that are getting sold to are in fact accredited investors. So those are things that I think will be important in the mix. If they don't need the protections of the securities laws, then it may make sense to make it easier to reach them. If they are the group that needs the protections of the securities laws because either they're not really accredited and they're getting, they have fraudulent brokers who are putting them into deals they shouldn't be in. So I'm very concerned about that factor, so I would like to, and so in that area those are the, those will be going into our, the staff's recommendation.

On the 500 holder limit, I would like to know what the investor makeup is in these companies and I would like to know what the characteristics are of these companies. Are these companies that are real companies? Are they more fraudulent companies that are trading in the sort of dark markets and held in street name and you don't really have, they have thousands of investors but they only count as 200 because they're held through brokers, or are these companies that are the engines of growth and they have 499 holders and they can't raise another dime because they can't get one more holder, and those are 499 actual investors. I think those are important points. And if the answers come out—we may need different answers for different kinds of companies, different situated companies, companies who go dark because they are held through street name might need a different test than companies that are held by investors directly and are bumping up against the limit and are in desperate need of capital.

Mr. CUMMINGS. Now with regard to those who need to be protected, will you be looking at, you said that you would, you're concerned about them, but then going back to some questions that Mr. McHenry asked about who it is that is in need of protection, do you all see that changing? In other words, is that something that you, is that a definition that you might want to revisit at some point? I'm just curious.

Ms. CROSS. Well, the accredited investor definition amended in Dodd-Frank to change the net worth test to eliminate the primary residence. And Dodd-Frank otherwise says that we're not to revise that definition, I believe it's 4 years. And GAO is doing a study of the definition in the meantime. So I don't see that as a definition we're changing on the immediate horizon but it is a definition that does need to be a living, breathing definition as investors change. For example, should there be a special accreditation for people who are chartered financial analysts who don't happen to have a lot of money for some reason, things like that; it might make sense to add people to the list.

Mr. CUMMINGS. Thank you very much, Mr. Chairman. I yield back.

Chairman ISSA [presiding]. I thank the ranking member.

I have only one question for you as a quick followup.

The current statute envisions that all investors are in one pool. So if a company has no program for their employees to own stock, no, any form of stock options, they could have 500 street name investors which could be thousands of actual investors through their—well, if a company has 1,000 employees they want to offer they have no choice but to in fact avail themselves of an alternative because the same 500 applies regardless, isn't that true?

Ms. CROSS. It's correct that the same 500 applies.

I think that for some companies that are traded in the over-the-counter markets, not on exchanges, they are held in street name; even though they're not reporting companies, those companies could also have their employees hold in street name in theory. Those are not the kinds of companies we're really talking about at this hearing. I think the companies you're talking about are the companies that are pre-IPO companies who are growing——

Chairman ISSA. Correct.

Ms. CROSS. —dynamically, and for those companies the employees being counted certainly weighs into a meaningful cap.

Chairman ISSA. OK, and that was just the point that I wanted to make sure we understood, that when we talk about protections, that it's, in fact, not a fixed protection. It can be a very large number by comparison if employees are not offered and a very small one if there were hundreds of employees in that mix.

Ms. CROSS. That's right.

Chairman ISSA. Thank you. And with that I thank you for your participation in this panel and your patience through all of it.

And we'll take a 5-minute recess to set up the second panel. Thank you.

Ms. CROSS. Thank you.

[Recess.]

Chairman ISSA. Thank you all for your patience. I noticed, I believe, all of you in the audience. So you know our questions. Now the question of course will be will your answers be similar to the first panel?

I knew I would get a laugh if I worked hard on it.

We now recognize our second panel.

Mr. Barry Silbert is the CEO of SecondMarket, an alternative trading system and a young entrepreneur in his own right.

Mr. Eric Koester is the cofounder of Zaarly, Inc.

Dr. Richard Rahn is Senior Fellow at the Cato Institute.

And Mr. Jonathan Macey is a law professor at Yale University.

Last but not least, the Honorable Roel Campos is the former Commissioner of the Securities Exchange Commission.

As you saw in the first panel, our rules require all witnesses be sworn. So please rise and take the oath.

[Witnesses sworn.]

Chairman ISSA. Let the record reflect that all witnesses answered in the affirmative.

And as in the first panel, we will take 5 minutes on our side, and I'll try not to cut anyone off mid-question or—and I won't cut any of you off mid-answer.

However, there's a lot more of you. So on your opening statements please limit yourself to 5 minutes, and with that, Mr. Silbert.

**STATEMENTS OF BARRY E. SILBERT, CEO, SECONDMARKET; ERIC KOESTER, CO-FOUNDER, ZAARLY, INC.; RICHARD W. RAHN, SENIOR FELLOW, THE CATO INSTITUTE; JONATHAN R. MACEY, SAM HARRIS PROFESSOR OF CORPORATE LAW, SECURITIES AND CORPORATE FINANCE, YALE LAW SCHOOL, PROFESSOR, YALE SCHOOL OF MANAGEMENT; AND ROEL C. CAMPOS, ESQ., LOCKE LORD BISSELL & LIDDELL, FORMER COMMISSIONER OF THE SECURITIES EXCHANGE COMMISSION**

## STATEMENT OF BARRY E. SILBERT

Mr. SILBERT. Good afternoon, Chairman Issa, Ranking Member Cummings, and members of the committee. My name is Barry Silbert, and I'm the founder and CEO of SecondMarket. I'm grateful for the opportunity to testify this afternoon regarding the future of capital formation, an important issue that directly impacts job growth and U.S. global competitiveness.

I founded SecondMarket in 2004 to create a transparent, centralized and independent market for alternative investments, including stock in private companies.

We've grown rapidly and now have 135 employees in New York and San Francisco and have completed several billions of dollars in transactions. We're a registered broker-dealer with FINRA and an SEC-registered alternative trading system.

SecondMarket's unique business model is premised on transparency and independence. We do not engage in proprietary trading, meaning we do not use our own balance sheet to purchase assets that are put up for sale in SecondMarket.

Up until a decade ago, fast-growing startups followed a very similar capital formation path. They raised venture capital, a few rounds of venture capital, and went public in about 5 years. For several decades, these small cap companies could thrive in the public markets with research coverage, brokers and market makers driving investor interest in these companies. The public market allowed companies like Starbucks, Intel, Genentec, and Dell to grow from small cap companies into job-creating economic powerhouses.

However, the capital formation process has evolved over the past decade, and the public markets are no longer receptive to small companies. It now takes companies twice as long—nearly 10 years—to grow to reach the public market.

A number of factors have contributed to the systemic problems that exist in the public market. These include a shift from stockbrokers to online trading, the inability for market makers to profit for supporting smaller cap stocks, the lack of research coverage on smaller companies, and finally, the implementation of Sarbanes-Oxley, which made it cost prohibitive to be a public small company.

You can read more about these issues in my written testimony.

One other important systemic change is the emergence of computer-driven, high frequency trading. Although it brings liquidity to the public markets, these traders ignore small cap companies and have contributed to the casino-like trading atmosphere in the markets. Disturbingly, it is estimated that nearly 60 percent of public trading volume is being done by computer algorithms, which has caused the average time that a public share of stock is held to decline from 5 years in 1970 to less than 3 months today.

The small cap market is a vital part of the capital formation process, and the failure of the U.S. capital markets to support these companies inhibits our ability to create jobs, innovate and grow. Consequently, a new growth market must emerge to support these companies, and I believe that SecondMarket is that market.

Chairman Schapiro has said that the SEC is reviewing the regulatory landscape to lessen the burden on private companies. President Obama has also ordered a review of government regulations that place an unnecessary burden on businesses. I applaud the commitment of the SEC and the administration.

I believe there are two regulatory hurdles in particular that must be reexamined. First is the so-called 500 shareholder rule. As discussed previously, pay structure at startup companies generally involve giving employees below market salaries coupled with stock options. These options enable employees to realize the financial upside while enabling the startup to hire top talent even though they don't have the cash to pay market salaries.

As a result, this rule has created a disincentive for private companies to hire new employees or acquire other businesses for stock as the companies are fearful of taking on too many shareholders and thus triggering a public filing requirement.

The second rule that must be reexamined is the prohibition against general solicitations. Given that only accredited investors are eligible to purchase unregistered securities, such as private company stock, we should strive to maximize the pool of investors that are aware of any offering. In short, let everyone see, but only let accredited investors invest.

Given the foregoing, I would respectfully propose the following rule changes: First, a significant increase or elimination of the 500 shareholder threshold. Second, if a threshold is increased but not eliminated, an exemption for accredited investors from that count. The SEC has already determined that these investors do not require registration level protection, and therefore this exemption would be consistent with the SEC's investor protection mandate.

Third, if the threshold is increased but not eliminated, an exemption for employee owners from the shareholder count. And finally, an elimination on the prohibition of general solicitation provided that the ultimate purchaser is, in fact, an accredited investor.

I believe the problems facing growth stage companies must be addressed and failure to support a new growth market will significantly limit access to capital, restrict job growth, stifle innovation, and weaken the United States globally.

Thank you again for the opportunity to participate in this important hearing. I would also like to thank the SEC for considering these important rule changes.

[The prepared statement of Mr. Silbert follows:]

secondmarket™
the marketplace for alternative investments

Written Testimony

of

Barry E. Silbert

Founder and CEO, SecondMarket

to the

Committee on Oversight and Government Reform

U.S. House of Representatives

"The Private Company Burden:

Solutions for Entrepreneurs, Job Creation and Innovation"

MAY 10, 2011

Good afternoon Chairman Issa, Ranking Member Cummings, and Members of the Committee. My name is Barry Silbert. I am the Founder and CEO of SecondMarket, which is the largest marketplace for alternative investments. I am grateful for the opportunity to testify this afternoon regarding this important subject that poses a significant challenge to our country. The issues raised in my testimony directly impact job growth and American global competitiveness.

First, I'd like to describe SecondMarket. Second, I will discuss the problems in the public equity markets that have made the markets inhospitable to growth-stage companies. Next, I will describe the important role that SecondMarket plays in the capital formation process and in affording access to capital. Finally, I will suggest certain regulatory changes that should be made to support growing private companies on their road to the public markets, while also maintaining a high level of investor protection.

**My Background and the SecondMarket History**

I was born and raised in Gaithersburg, Maryland and attended college at Emory University in Atlanta. After graduating in 1998, I started my career as an investment banker at Houlihan Lokey where I worked on some of the most prominent bankruptcies of the last decade, including Enron and WorldCom. Houlihan typically represented creditors, and the experience working on complex, problematic restructurings proved invaluable. It was this experience that led me to the idea for SecondMarket.

Upon emerging from bankruptcy, creditors in Chapter 11 cases would sometimes receive stock in the restructured company that was not saleable in the public markets. Oftentimes, these creditors would contact Houlihan to inquire about selling these instruments. When I asked my colleagues how we could assist the creditors with these sales, it was suggested that I should pick up the telephone, start calling my contacts, and find buyers. I was struck that there was no centralized marketplace for these assets. Thus, the idea for SecondMarket was born: a transparent, centralized and independent marketplace where buyers and sellers could transact in alternative assets.

Having long ago decided I wanted to eventually start my own company, I left my Wall Street job and began drafting a business plan. Although the idea has evolved over time, I have always been committed to the notion of providing transparency and centralization to markets that had historically been fragmented and opaque. I founded SecondMarket in New York City in late 2004, and we opened for business in 2005. We started small and low-tech – just five guys in a tiny office with a few computers and phones.

The first illiquid asset class that we focused on was restricted securities in public companies. These are assets such as restricted stock, warrants and convertibles that are issued by public companies but not tradable in the public stock markets. Since that time, SecondMarket has experienced significant growth, as we have added several more asset classes that benefit from our core principles of transparency, centralization and independence.

What do these principles mean? Transparency means providing detailed information about the asset so that buyers and sellers can make informed investment decisions. It also means transparency into asset pricing. Centralization means bringing together buyers and sellers in a formalized, secure marketplace. Independence means we are not a subsidiary of another financial institution and, more importantly, we do not engage in proprietary trading. Thus, we do not use our own balance sheet to complete transactions. We are willing to sacrifice short-term revenue opportunities because we believe that as a global marketplace, it is critically important that our participants recognize that we are not on either side of the transaction. We are always the marketplace connecting buyers and sellers, guiding our participants through the sales process, and handling the closing and settlement of the transactions.

Since launching the first asset class in 2005, we have added markets for structured products (e.g., auction-rate securities, mortgage-backed securities, etc.), bankruptcy claims and private company stock. These asset classes have unique characteristics, objectives and participants. However, they share the common thread that they are illiquid, alternative investments that benefit from a centralized marketplace.

While we have continued to add new asset classes, the size of our participant base has also grown. At the beginning of 2009, we had 2,500 registered participants on SecondMarket. At the outset of 2010, we reached 6,500. Today we have well over 50,000 participants and the number is constantly growing. Our technology has also evolved substantially as we have invested millions of dollars into our online platform, which provides centralization and efficiency to improve the user experience and streamline the sales process.

Moreover, we are no longer a few individuals in a small office. SecondMarket now employs approximately 135 people in New York and San Francisco, and we are hiring new employees every month. I should also note that SecondMarket has been a FINRA registered broker-dealer and operates an SEC-registered Alternative Trading System, or ATS.

SecondMarket is the leading marketplace for facilitating transactions in private company stock. We have completed trades in over 50 different companies, including Facebook and Twitter. In 2008, we completed $30 million in private company transactions. In 2009, that number rose to

$100 million and in 2010, we saw nearly a four-fold increase in transactional value. To date, we have conducted nearly $700 million in completed private company stock transactions. Across all of our asset classes, we have completed several billion dollars in trades.

SecondMarket has emerged as an innovative solution provider. We have helped retirees get liquidity when their auction-rate securities (which were often marketed as a cash equivalent) turned out to be long-term, illiquid investments. We have been part of the sales team working in conjunction with Deutsche Bank to help the Treasury Department sell TARP warrants. And we've helped dozens of private companies provide liquidity for their shareholders, many of whom reinvested their money into other startups.

**Problems in the Public Stock Markets**

For several decades, startup companies in the U.S. followed a familiar path. They raised angel capital, a few rounds of venture capital, and went public within five years. The vast majority of IPOs were for companies raising $50 million or less, even adjusted for inflation. Smaller public companies could thrive in the public markets, with equity research coverage and market makers driving investor interest in growth-stage companies. Somewhere along the line the market structure changed, and the public markets became inhospitable to smaller public companies.

Although SecondMarket is not a research company, we closely follow research findings from industry observers and analysts.[1] Several factors have been recognized by these market observers as contributing to the problems in the American public stock markets:

- Online Brokers – although the introduction of online brokerages helped to make trading less expensive, these online brokers disintermediated retail brokers who helped buy, sell and market small-cap, under-the-radar public companies to investors. Stockbrokers collectively made hundreds of thousands of calls per day to their clients to discuss small-cap equity opportunities, and the proliferation of online brokerages decimated the profession. Those brokers provided a critical marketing tool for the country's small-cap companies.
- Decimalization – stock prices used to be quoted in fractions, and the difference between fractions created profit for firms providing market making, research and sales support. When the markets began quoting prices in decimals, trading spreads were reduced and profits were significantly cut. It became unprofitable to market small-cap equity.
- Sarbanes-Oxley – the legislation is often blamed for the problems in the public markets, but most observers believe it is not the most significant factor in companies electing to remain private. Nonetheless, corporate compliance with the Sarbanes-Oxley Act has certainly increased costs for public companies.
- Global Research Settlement – once the investment banks began funding equity research, conflicts of interest emerged and positive equity reports began to be written for

[1] *See* "A Wake-Up Call For America," David Weild and Edward Kim, Grant Thornton Capital Markets Series, Nov. 2009; "Market Structure is Causing the IPO Crisis – and more," David Weild and Edward Kim, Grant Thornton Capital Markets Series, June 2010; "It's Official: The IPO Market is Crippled – and it is hurting our country," Alan Patricof, *Business Insider*, Jan. 2011; "Wall Street's Dead End," Felix Salmon, *The New York Times*, Feb. 2011; "Welcome to the Lost Decade (for Entrepreneurs, IPOs and VCs)," Steve Blank, July 2010.

undesirable companies. This issue caused state Attorneys General to get involved, eventually resulting in the global research settlement. The result was that research reports stopped being written for small-cap public companies and, consequently, a significant marketing mechanism for small-cap companies was eliminated.

- High-Frequency Trading – although high-frequency traders bring significant liquidity to the public markets, they require the volume and velocity that can only be found in large public companies. A recent report stated that high-frequency traders conduct more than half of the trades taking place in the U.S. equity market, and those traders essentially ignore small-cap companies.[2]
- Average Hold Period – over the past forty years, the average time that a public market investor holds stock has dropped from approximately five *years* in 1970, to less than three *months* today. This further highlights the fact that investors are now focusing their attention on short-term earnings performance, versus long-term, business-building initiatives.[3]

Virtually all of these developments emerged from either well-intentioned policy decisions or the natural evolution of the markets in an electronic age. Nonetheless, taken in the aggregate, these (and other) factors have made the public markets undesirable for many companies. Throughout the 1980's and 1990's, the regulatory environment and overall market structure actively supported high-growth private companies joining the public markets. From 1991 to 2000, there was an average of 520 IPOs per year, with a peak of 756 IPOs in 1996.

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[2] "High-Frequency Boom Time Hits Slowdown," Jeremy Grant, *The Financial Times*, April 2011 (citing data from The Tabb Group).

[3] "Investing Dying as Computer Trading, ETFs & Dark Pools Proliferate," John Melloy, *CNBC*, Jan. 2011.

Today, the lack of a properly functioning public market structure is strikingly obvious. Since 2001, the United States has averaged only 126 IPOs per year, with 38 in 2008, 61 in 2009 and 71 in 2010.[4] Companies are electing to remain private longer than in previous decades, and the average time a company remains private has essentially doubled in recent years.[5]

Simply put, the lackluster IPO market is not providing the solution for investors and early employees who need liquidity. M&A is an alternative option for companies to obtain liquidity; however, acquisitions often result in job losses and stifled innovation. The growth market is a significant and vital part of the capital formation process, and the systemic failure of the US capital markets to support healthy IPOs inhibits our economy's ability to create jobs, innovate and grow. Clearly, a new growth market must emerge.

**The SecondMarket Solution**

We were first approached about facilitating trades of private company stock in late 2007. A former Facebook employee contacted us and asked if we could help him sell his stock. He had read about how we facilitated transactions in restricted stock in public companies. Since Facebook was not a public company, the stock was unregistered and Facebook did not have any plans for an IPO. We facilitated the transaction and then took a step back to assess the viability of the market. Once we understood that companies were remaining private much longer than in prior years, and that systemic changes in the public markets make it difficult for companies to go public, we were convinced that we could help to fill the role of a new growth market.

[4] "Market Structure is Causing the IPO Crisis – and more," David Weild and Edward Kim, Grant Thornton Capital Markets Series, June 2010.

[5] *Id.*

The SecondMarket approach is premised on the notion that there is not a "one-size-fits-all" model for private companies. Each company has its own goals and objectives. Some companies value control and flexibility, others are more concerned with liquidity and valuation. Thus, we allow companies to dictate the essential elements of their marketplace, such as identifying eligible buyers and sellers, setting the amount or percentage of shares to be sold, and determining the frequency of transactions. Some companies want only former employees to sell, and some want only existing shareholders to buy. Some permit weekly trading, but many prefer to establish quarterly or annual liquidity events. Some choose to allow an open market where buyers and sellers negotiate the share price on a one-off basis, and some elect to run an auction.

When a company uses SecondMarket to set up a liquidity program, we require the company to provide financial disclosures to eligible buyers and sellers. Companies are increasingly comfortable with the mechanics of our market as they recognize that information they provide is only available to the companies' selected buyers and sellers in a secure, online data room administered by SecondMarket.

In developing the private company market, SecondMarket has become an important part of the capital formation process. By helping companies provide interim liquidity to shareholders, we essentially operate as a bridge to an IPO for companies that eventually want to go public, or as an alternative option for companies that wish to remain private.

**Suggested Regulatory Changes**

SEC Chairman Mary Schapiro recently informed this Committee that the SEC is reviewing the regulatory landscape to lessen the burdens on private companies. In his State of the Union address this year, President Obama ordered a review of all government regulations. He added:

"When we find rules that put an unnecessary burden on businesses, we will fix them."[6] I applaud the steadfast commitment of the SEC and the Administration, and I believe there are regulatory fixes that can and should be made at this time. Rule changes in this area would directly impact companies' ability to access capital more readily and cheaply, help companies retain existing employees and hire new ones, and bolster American global competitiveness. At a time when our lawmakers, policymakers and regulators debate how best to create new jobs, I believe a few minor changes to the regulatory rules could have a major impact on job creation.

Venture-backed companies fuel job growth in this country.[7] According to the Kauffman Foundation, startups create an average of three million new jobs annually and the most new net jobs in the United States.[8] It is essential that the regulatory framework recognizes this dynamic and permits these startups to flourish.

Over the past few years, I have developed strong relationships with executives at numerous private companies. These executives are often concerned that they are not ready or able to successfully navigate the public markets. They are also concerned about regulatory hurdles that restrict their ability to remain private. The concerns are varied, but two particular regulatory hurdles are often identified:

- The so-called "500 Shareholder Rule" codified in Section 12(g) of the Exchange Act, which compels private companies to become public reporting companies once they have

[6] Remarks by the President of the United States in the State of Union Address, The White House, Jan. 2011.

[7] Venture-backed companies in the United States account for more than 12 million jobs, or 11% of the total private sector employment. *Venture Impact: The Economic Importance of Venture Backed Companies to the US Economy,* National Venture Capital Journal and IHS Global Insight, 2009.

[8] *The Importance of Startups in Job Creation and Job Destruction*, Kauffman Foundation Research Series: Firm Formation and Economic Growth, July 2010.

exceeded 499 shareholders and have more than $10 million in assets at the end of any fiscal year.

- The prohibition against "general solicitations" and "advertising" in connection with private placements of unregistered securities, which has been interpreted to mean that potential investors must have a pre-existing relationship with an issuer or intermediary before the potential investor can be notified that unregistered securities are available for sale.

These two regulatory restrictions have been in place for several decades. The shareholder threshold – which, incidentally, was initially set at 750 before being reduced – was established in 1964 and worked well for several decades. For many years, companies were going public within a few years of founding, and were not getting close to the shareholder count. That, however, is no longer the case.

The pay structure at startup companies generally involves giving employees below-market salaries along with options which vest over several years. The options are an economic incentive that allows employees to realize the financial upside of contributing to a successful startup. The companies prefer to give equity in lieu of cash compensation because startups generally need to conserve capital in order to grow the business. Option holders do not, in fact, count against the 500 Shareholder Rule, so awarding options to employees does not adversely impact the shareholder count until the option holders exercise the options. However, in the new reality of companies taking nearly a decade to go public, option holders are often fully vested well before an IPO, and shareholders who exercise their options *are* counted under Section 12(g).

The significance of this development cannot be overstated. The 500 Shareholder Rule has created a disincentive for private companies to hire new employees, or acquire other businesses for stock, as these private companies are fearful of taking on too many shareholders. Application of the rule also discourages companies from providing stock option-based compensation to employees, removing one of the great economic incentives attracting the country's best and brightest employees to startups. The rule must be reexamined in light of the new reality that companies are remaining private much longer than in previous decades.

The prohibition against general solicitations is similarly problematic. Under many of the existing SEC exemptions for private placements, only "accredited investors" are eligible to purchase private company stock. An individual must meet certain financial standards to qualify as an accredited investor, and the definition was recently amended in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") to exclude an individual's primary residence from the calculation. The SEC and Congress recognize that sophisticated, accredited individual and institutional investors have greater capacity for risk and do not require the enhanced protections provided to the average retail investor.

As previously noted, the prohibition against general solicitations and advertising requires issuers and intermediaries to have a pre-existing relationship with the accredited investor in order to make offerings available. In fact, if a non-accredited individual even *views* an offering of unregistered securities, the entire offering may be in violation of the prohibition against general solicitations.

Frankly, if only accredited investors are eligible to purchase unregistered securities, shouldn't we strive to maximize the pool of accredited investors that have access to the offering? It should not matter that non-accredited individuals know that unregistered securities are available for sale. No one prohibits car manufacturers from advertising, even though children under the legal driving age are viewing the advertisements. The general solicitations prohibition unnecessarily limits the pool of potential investors, thereby restricting companies' ability to raise capital to fuel growth.

Given the foregoing problems in the regulatory landscape, I would respectfully propose the following solutions:

1. A significant increase or elimination of the 500 shareholder threshold.
2. If the threshold is increased but not eliminated, an exemption for accredited investors and Qualified Institutional Buyers from the shareholder count. The SEC has determined that these investors do not require registration-level protection. Thus, implementation of this exemption would not breach the SEC's investor protection mandate.
3. If the threshold is increased but not eliminated, an exemption for naturally well-informed employee-shareholders from the shareholder count.
4. An elimination of the prohibition on general solicitations in the context of private placements and resales of unregistered securities, provided that the ultimate purchaser meets the accredited investor qualifications.

These rule changes would significantly ease the pressure on growth-stage companies in this country. It is important to note that these concepts did not originate from SecondMarket.

Rather, industry experts and participants have for many years advocated the implementation of these exact changes.[9]

In 2009, the SEC kindly invited me to participate in its Small Business Capital Formation Forum. I accepted the invitation and participated in a panel regarding the state of small business capital formation. I also listened to multiple panelists advocate for some or all of these changes. In fact, for several years, the Forum's participants have recommended to the SEC the proposals we are making today.

I recognize that passage of Dodd-Frank significantly added to the SEC's rulemaking responsibilities, and implementation and enforcement of these new rules will be challenging. Nonetheless, I believe the problems facing growth-stage companies in this country must be addressed, and these tailored, straightforward recommendations are steps in the right direction. Failure to adapt to the fundamental new reality that companies remain private longer will restrict job growth, stifle innovation, and weaken America globally.

**Conclusion**

In summary, I want to thank Chairman Issa, Ranking Member Cummings, and the members of the Committee for the opportunity to participate in this important Hearing. I also want to thank the SEC for consideration of these rule changes. As SEC Chairman Mary Schapiro indicated in her letter to Chairman Issa on April 6, 2011, ".....facilitating capital formation, along with protecting investors and maintaining fair and orderly markets, is the mission of the Securities and Exchange Commission." Along those lines, it is imperative that decades-old rules and regulations are updated to reflect the new realities of market structure, technology, and

[9] *See, e.g.*, Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission, April 2006 (advocating eliminating the prohibition against general solicitation).

information flow to better support the thousands of innovative, growth-stage companies in our country. In this period of slow economic growth and increasing global competitiveness, we need to support these types of companies with all available resources and ensuring cost-effective access to capital is an important first step.

Thank you.

Chairman ISSA. Thank you. Mr. Koester.

**STATEMENT OF ERIC KOESTER**

Mr. KOESTER. Hello. Thank you, Chairman Issa, Ranking Member Cummings, and members of the committee. My name is Eric Koester, and I'm one of the founders of Zaarly, a location-based, realtime, community-powered marketplace launching—crossing your fingers—nationwide this month. I greatly appreciate the time to come before you today.

I am what Mr. Silbert earlier described, a hopeful fast growing company. And as a former startup lawyer turned entrepreneur myself, I have had the unique opportunity to advise, counsel, and educate thousands of entrepreneurs and early stage businesses as well as live the life of business owner myself. Therefore, I have seen some of the challenges affecting today's entrepreneurs and small businesses firsthand.

My testimony today is aimed to highlight specific concerns from the mouths of entrepreneurs that affect the ability of our young companies to hire and increase jobs, to innovate, to compete globally, and to grow our broader economy.

Today I would briefly like to tell the story of why it is important to act to decrease friction for entrepreneurs and small businesses, to increase liquidity in our private markets, and to regain the leadership position to support early stage businesses.

Others on this panel may be better suited to provide information such as data, research and analysis on broader market trends, but my purpose as an entrepreneur here today is to share how some of these regulations can impact our ability to fund and grow these emerging small businesses.

Today's economy is very different, and entrepreneurs and small businesses have unique opportunities. In speaking with entrepreneurs and myself, I believe there's a few key lessons that we can learn from the proverbial entrepreneurial field.

First, building a small business today is actually cheaper and easier than it's ever been before in our Nation's history.

Second, and a big however, building a business is not cheap, and it still requires substantial resources and investments to make these businesses thrive.

No. 3, raising funds in itself is difficult, and it has become more difficult given the decreased liquidity of our banking system, and identifying prospective investors is extremely distracting to the task of building and starting a new growth business.

And fourth, the most important lesson learned from entrepreneurs today is that removing friction, friction in business, friction in commerce, friction in human capital and, important to this economy committee today, regulatory friction is crucial to be able for these businesses to do more with less.

I would like to tell a brief story about my current business, Zaarly, and why I think that removing friction is so important to the success of other businesses like ours.

My business was just an idea 11 weeks ago. In the last 11 weeks, we've been able to hire a team of nearly a dozen individuals, nearly 50 contractors, open two offices, deploy robust technology solution, raise funding and hopefully file several patents and trademarks to ready a marketing effort to take the Nation by storm—we hope—this month. Our goal is to be, with some luck and support of customers, the next Amazon, eBay or Groupon.

The important lesson to learn about Zaarly is that we've launched this market in a very short and rapid time, leveraging the speeds and the trends in industry. But what's also important to know is that other businesses may not have the advantages that a Zaarly has by having a reformed corporate lawyer on their team to navigate some of the difficult legal issues.

So the story of Zaarly and its rapid growth and hopeful success from here highlights some several lessons. It highlights that the regulatory schemes are very complex for early stage businesses and are distracting to their success.

Sufficient funding resources are crucial to their speed and there are dozens of ways for these businesses to trip up on the existing regulatory scheme. So alternative funding schemes are important to find and to reduce the operational expense of taking a business from a startup to a successful business venture.

Therefore, I'd like to propose and encourage the Commission and this entire committee to look at four important things: Continue to examine private company fundraising and financing regulations, including things such as general solicitations and the ability of private investors to be deemed accredited when they are sophisticated investors.

Second, to explore more options like private market regulations, like my colleague Mr. Silbert's SecondMarket, which can increase liquidity for lower tier businesses in the chain such as myself.

Third, to explore the options for community funded or funding organizations where small dollar amounts contributed by the community can be used to fund businesses like mine.

And finally, while not within the purview of this committee, I think it's important that the immigration reform impacting startups, such as the startup visa program, H–1B visa extensions be explored.

I want to express my gratitude for being here today and thank you very much for exploring these important issues. Thank you for your time.

[The prepared statement of Mr. Koester follows:]

Zaarly

**Written Testimony**

**of**

**Eric Koester**

**Founder and Chief Operating Officer, Zaarly**

**to the**

**Committee on Oversight and Government Reform**

**U.S. House of Representatives**

"The Future of Capital Formation"

*MAY 10, 2011*

Hello and thank you to Chairman Issa, Ranking Member Cummings, and Members of the Committee.

My name is Eric Koester. I am the one of the founders of Zaarly, a location-based, real-time community marketplace launching (crossing fingers) nationwide this month. I greatly appreciate the chance to testify before you today.

As a former startup lawyer turned entrepreneur myself, I've had a unique opportunity to advise, counsel and educate thousands of entrepreneurs and early stage businesses, as well as to live the life of a business owner. Therefore, I have seen the challenges affecting today's entrepreneurs and small businesses first-hand. My testimony today is aimed to highlight specific concerns from the mouths of entrepreneurs that affect the ability of our young companies to hire and increase jobs, to innovate, to compete globally and to grow the broader economy.

Supporting entrepreneurship, startups and small business is about as American as apple pie. But I feel that if we are not careful and cautious, we run the risk of snuffing out our brightest future stars before they have the chance to grow into the next Home Depot, Office Max, Microsoft or Apple.

Today I would like to tell the story of why it is important to act to decrease friction for entrepreneurs and small businesses, to increase liquidity in the private markets, and to regain a leadership position in the support of early-stage businesses. Others on this panel will be better suited to provide information, data, research and analysis on broad market trends, financial markets and public offerings. My purpose it so showcase how regulatory issues impact the business owner or new entrepreneur. These individuals represent the next Facebook, Amgen or Costco, and removing barriers to their success is critical. First, I will quickly share the story of my journey from lawyer to entrepreneur, and offer lessons from the mouths of other entrepreneurs – stories that form the baseline of my support for certain of my key recommendations below. Second, I will share the story of my company Zaarly, which I believe is an example of the importance of decreasing regulatory friction on early stage businesses. Finally, I will discuss several key initiatives that I believe should be enacted, enabled or reformed to spur entrepreneurship, innovation, investment in private companies and the broader growth of our economy.

**My Journey: From Lawyer to Entrepreneur**

When I was a child, I'd grown up watching my father leave Enron (before its downfall) to start his own business. I was even more fortunate to be able to spend my summers and hours after school helping with tasks and odd jobs around his office. It was those early experience that led me to undertake some consulting work and some web design in high school and college – in what I'd call my earliest "entrepreneurial" activities (save those neighborhood lemonade stands while in grade school).

After college, I took a more traditional route beginning my career at a large public, financial services company before transitioning to a smaller public, biotechnology company. After a few years in 'corporate' America, I returned to school to earn my law degree and became an attorney at a large, five hundred person plus law firm, focusing on corporate and securities law. In spite of working for such a large law firm, I was fortunate to join a practice with a specialization in startups, small businesses, early-stage private companies and entrepreneurs to satisfy my own entrepreneurial leanings. Following nearly five years in the legal trenches advising entrepreneurs and assisting with corporate transactions from formation to equity and debt financings to mergers and acquisitions, I took my first steps into the startup realm by joining one of my clients, a venture-backed company in Seattle, and just five months later I officially took the "leap" to found my own business, Zaarly, which I'll speak about further.

While taking this leap to entrepreneur has been extremely fulfilling and rewarding, owning your own business is a guaranteed way to get more grey hair and less sleep. Founding a business is a difficult and challenging proposition – as the founders have each forgone paychecks and time with our families to hopefully build something great together. The founders of Zaarly are fortunate to each have some savings and to have received investment early in our tenure, but such a leap is not without its share of risk and challenge.

And while we as a society reward the victors of the entrepreneurial 'leap' such as Steve Jobs, Bill Gates, Sam Walton, Richard Branson and T. Boone Pickens, there are countless individuals that will never get rich, will never grace the cover of a magazine, and may actually find financial ruin. Because of the risks these entrepreneurs take and the rewards such risks provide for us as a country and a society – from technology and medicine to safety and convenience – I believe it is important to encourage innovation, calculated risk-taking and broad entrepreneurship.

My journey from lawyer to entrepreneur has taught me that most individuals become entrepreneurs because they believe they can make a difference in the world – which is the very reason I left legal practice to found Zaarly. Our goal is to revolutionize person-to-person commerce and help to connect communities of buyers and sellers living and working next to one another. As we decrease friction in our economy for want-rapreneurs[1] to become entrepreneurs (more funding sources, simplified regulations, etc.), the hope is that more entrepreneurs can begin to revolutionize society themselves.

**From the Front lines: Entrepreneurs, Business-owners and Startups**

My story is not unique and my time in the entrepreneurial community as an entrepreneur, a startup lawyer, an advisor, and a volunteer has given me a unique window into the minds of others in the entrepreneurial community. Today's entrepreneur, being an owner of a

[1] The phrase "want-rapreneur" is used to describe an individual with substantial interest and initiative in entrepreneurship that has not yet joined or started his or her own venture. Due to factors such as risk-aversion, lack of a team, or other factors, a want-rapreneur is unable or unwilling to become an entrepreneur and either found a business or joins an early-stage venture.

neighborhood bakery, a person listing their crafts on Etsy or eBay, an independent auto mechanic or an owner of a technology-based business like myself, is driven by one overriding fact: Do More Faster. I have recognized this in my brief stint as a full-time entrepreneur, being pushed to build a product faster, scale a marketing team faster, and meet consumer demand faster than ever. But this speed also provides incredible opportunity to fill unmet market needs or to create a new way to do business.

An outstanding example of the "Do More Faster" mantra is a Seattle-based nonprofit, Startup Weekend.[2] Startup Weekend is an organization that aims to provide experiential education for entrepreneurs, offering low-cost educational programs for individuals interested in forming businesses or learning more about entrepreneurship. Startup Weekend's signature 54-hour event allows an entrepreneur to go from idea to prototype in a weekend. This has led to more than 3,000 startups being prototyped in the past 3 years. This organization and its participants showcase the speed of technology and the power of the entrepreneurial ecosystem.

What took eBay nearly ten years to accomplish in size and scope, took Groupon only two years. And while technology has provided newfound speed to market, it has also brought with it the ability of global competition to catch-up to American entrepreneurs at record speed. Fast-growing businesses from Groupon to Twitter to Facebook has each faced new challenges from international copycats, which eBay did not truly face in its early days. Now, an entrepreneur is pushing to 'do more faster' just to prevent competition or copycatting from smart, well-trained and well-funded (often by government funds) entrepreneurs and businesses in nations and cities around the globe. It's no longer a race between businesses with broad ambitions in Boston, Austin, Miami or Los Angeles. Now, it is a race between entrepreneurs in Beijing, Mumbai, London and Sao Paolo.

So just how are today's U.S. entrepreneurs working to 'doing more faster'? There are many ways, from better training, sharing of information and identifying a better workforce. But perhaps above all else is the use of technology. By utilizing technology to sell over the Internet, to save money, to set-up remote offices, to allow home-based workers, or to reach new markets, businesses are quickly able to gain efficiencies. At every turn, business owners and managers are trying to squeeze more out of each hour and each dollar... trying to 'do more faster.' These tools are not only in the hands of U.S. businesses; they are in the hands of everyone with a computer and an Internet connection, making the stakes all the more important.

And while these entrepreneurs continue to try to do more, and do it more quickly to beat international competitors to market, these U.S. entrepreneurs are also faced with externalities that limit their ability to move quickly, to take calculated risks, and to build the next great American businesses. These externalities are what I like to call "friction points." Friction

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[2] Eric Koester currently serves as a volunteer advisor to Startup Weekend, a Washington state non-profit company, and serves as the interim general counsel (pro-bono). Eric has no economic or other interests in Startup Weekend.

points are places in business, commerce, regulation and life that slow down a business or a business owner from being able to 'do more faster.' If a machine has obstacles or 'friction points' that slow its operating speed, break its parts, or require maintenance (or worse, the machine to be shut down entirely), we lose efficiency, speed and ultimately dollars. In the same way, friction points from regulations limit efficiency and cost businesses billions annually.

However, I do not suggest that we should scrap all regulations and make America the 'wild west' of capitalism. I agree that regulations are important and serve a key need within our society and the business community. Instead, I suggest that some of the current regulations and regulatory scheme place an unfair and undue burden on the entrepreneurs who least need these friction points. These friction points are discussed in more detail below.

From spending time with entrepreneurs and small business owners, I believe there are a few key lessons from the proverbial "entrepreneurial field."

1. Building a small business is cheaper and easier than ever before.
2. However, building a business is not "cheap" and still takes substantial resources.
3. Raising funds is difficult and identifying prospective investors is extremely distracting to the task of building a business.
4. Removing friction (business, commerce, human capital, regulatory) is crucial to be able to do more with less.

While the earlier example of Startup Weekend producing thousands of new entrepreneurs and startups is a positive one, the challenges set forth above limit the number of these potential businesses that become a full-time priority for these want-rapreneurs. In the U.S., many of the businesses and projects begun at Startup Weekends remain weekend projects or part-time projects because of that hurdle of initial funding and overwhelming regulations. Outside of the U.S., the same startups formed from Startup Weekends abroad are more likely to receive support from governments and business leaders, taking these projects to a full-time business with greater frequency.

This is a simple, but troubling example that highlights the fact that the U.S. cannot rest of its past successes and an ecosystem without a bridge from idea/prototype to a true business. In the earliest days businesses may only need relatively small dollar amounts (oftentimes measured in thousands of dollars) to transition from a weekend project to a true entrepreneurial venture. However, the high compliance costs of such raising small dollar amounts cause these projects to languish.

With new firms (those in business less than five years) accounting for the vast majority of job creation in the U.S., it is without question important to our economic future to remove friction points and encourage today's risk-takers to build tomorrow's anchor businesses. This means continuing to reward risk, support failure and encourage innovation. As a society, our regulations are meant to protect all parties and to continue the practices that initially placed the U.S. at the center of the innovation economy.

**The Story of Zaarly: Why "Fast" is the New Black**

The story of Zaarly offers an important case study into the importance of removing barriers and friction points, and why smart regulations can encourage innovation and spur innovation.

It is somewhat difficult to believe, but eleven short weeks ago, Zaarly did not exist. It did not exist as a company, as a team of employees or even as a "fully baked" idea. However, in the past 11 weeks, a small and dedicated team has been able to build a robust technology product, raise funding from angel investors, open two offices, hire a nearly a dozen employees, retain numerous contractors, file for several patents and trademarks and ready a marketing and roll-out strategy. It is our hope that with some luck and the support of consumers that we can build the next great electronic commerce company in the vein of Amazon, eBay or Groupon.

We at Zaarly are one of the fortunate early-stage companies – a by-product of an interesting idea, good timing and an experienced team. But were it not for that idea, timing and team, our company might not be preparing for a nationwide launch. Today, we have engaged in substantial job creation, innovation development and some very broad ambitions, all of which are supported by some very forward-thinking investors and a dedicated team. The specific reasons behind the speed and early-success of Zaarly can be debated extensively, but it is without question that the ability to understand the formation, founding and funding process allowed our team to move with deft speed and to "Do More Faster." We are fortunate to know accredited investors, to be able to avoid any sort of general solicitation, to be able to limit our shareholder base, and to know to bypass funding sources that won't pass muster. However, this process and knowledge is not possible for most companies and even for those that have this good fortune, it is by no means easy and takes a team with dozens of companies to their credit and hundreds of advisory experiences.

It is unfortunate, but there are dozens and dozens of ways an entrepreneur can hit friction points in the current regulatory scheme. This is why I respectfully urge the parties gathered here to take actions to eliminate such friction – and to make it so that any business can move fast, even without the experience of dozens of startups and a securities lawyer on the team. Zaarly was just one of fifteen companies that was "founded" over a weekend in February at a Startup Weekend held in Los Angeles. But the reality is that many more of those entrepreneurs and businesses *could* or *should* be full-time endeavors for the individuals that founded them three months ago.

The story of Zaarly highlights the following important lessons:

1. Regulatory Schemes are complicated for early stage businesses
2. Sufficient funding sources are crucial to speed
3. There are dozens and dozens of ways to trip up a business along the way through the founding, formation and funding path
4. Alternative funding sources without high operational costs are crucial for encouraging want-rapreneurs to become true entrepreneurs.

Again, I do not intend to state that we should make it riskless to undertake any entrepreneurial venture nor do I say that we should not put in place certain protections for parties working with or investing in early-stage businesses. However, I posture it is incredibly important for the country to focus on obstacles that prevent individuals from beginning or joining true entrepreneurial ventures.

**Leverage Your Best Assets: Unfair Advantages**

The final and perhaps most important piece of this testimony is to provide recommendations based on personal experiences in the startup ecosystem. The U.S. entrepreneurial ecosystem has been the envy of the world and therefore other countries have done a great deal of research and investigation into how to spur innovation in their countries. We in the U.S. have the distinct advantage of a population that fosters and encourages innovation, risk-taking and entrepreneurial behaviors. And, as a result, it is crucial to utilize these "unfair advantages" to hold a leadership position in the world of innovation.

While these unfair advantages are clearly the first step towards new job creation, innovation development and economic competitiveness, it is also in our interest to eliminate barriers that slow the effectiveness of this unfair advantage in fostering innovation.

I respectfully submit that with the changes in the business culture encouraging business and entrepreneurs to "do more faster", it is even more important today to identify ways to regain competitive excellence in support for early stage businesses. And, given the experience of Zaarly, a business able to utilize nearly forty years of experience in the startup ecosystem to move quickly, build a team and product, and launch a consumer product, it is clear that the more we can eliminate common points of friction, the better for our broader innovation economy.

I respectfully encourage several approaches to reform and modify existing policies to better support entrepreneurs, small businesses and startups. I group these approaches into three broad categories, with a fourth important category to encourage innovation that may be outside the scope or the purpose of this hearing (but still of key importance):

1. Private Company Fundraising and Financing Regulations

In general, I respectfully request that regulations governing private company financing be thoroughly examined with an eye to decrease the regulatory scope, simplify procedures, and ensure that the cost-benefit of regulations for raising funding for small investments be met. Investors continue to be in the best position to protect themselves in their investment decisions. This may include contractual requirements for audits of financial statements, seats on a board of directors, or the receipt of regular financial statements.

More specifically, I encourage the removal of the Ban on General Solicitations, which limits the ability of private businesses to locate and identify prospective investors. In addition, I encourage the creation of regulations to extend/expand the concept of accredited investors to individuals that are deemed to be sophisticated based on their knowledge, experience, education or training, thereby allowing these individuals to participate in the private company investment market.

2. Private Market Regulations

For many fast-growing private companies, there are two traditional paths to providing for liquidity of their stock for investors: a sale of the company or an offering on the public markets. Yet with the increasing costs of public company compliance and offerings, a third approach has developed that now offers shareholders and employees limited liquidity while reducing some of the burden on these fast-growing businesses: private markets.

For later-stage businesses, these private markets offer an alternative to a sale of the company or a public offering to provide liquidity to investors and employees. At the same time, this provides a greater sense of visibility and market pricing into the valuation of a business. This alternative option has an added benefit for early-stage businesses – it provides confidence for early stage investors that more than a single path to an exit event exists. Now, investors have the option of public or private offerings and a merger or acquisition event.

As a result, I respectfully urge the creation of more flexible rules and regulations to permit businesses to remain private companies, while allowing for the additional liquidity these private market provide. This includes modifications to the 499 shareholder threshold rules and the related solicitation regulations.

3. Community-Funding Opportunities

Today's businesses are looking for funding from new sources (community-powered investment, angel investors, alternative loan structures, revenue-factoring, etc.) Dozens of organizations are powering microloans, crowd sourced social entrepreneurship and group-powered projects, most of which remain focused on international entrepreneurs or for non-profit aims. Yet the reality is that these structures provide a unique and powerful solution for current funding shortfalls affecting today's small businesses and startup companies. Imagine a day when a community can come together and fund community-centered businesses through microloans, micro-investments or crowd-sourced funding. It is important for the continual protection of investors, but we should take lessons from organizations using microlending and crowd sourced funding to alleviate poverty in other nations to also spur private investment in community-organizations.

I respectfully encourage the investigation of regulations to permit groups of individuals, businesses and organizations to make investments in private companies, small businesses and startups.

4. Immigration Reform

As an entrepreneur and supporter of the entrepreneurial eco-system, I also urge the Congressional leadership here to consider the importance of immigration reform in the long-term success of this sector. While not directly related to the hearing at hand, I urge a strong examination and consideration of two key programs which directly support and benefit the startup ecosystem:

a. Expansion of visa programs for individuals intending to work at early-stage businesses. Talent remains at a premium and there is a clear shortfall of citizens and foreign residents with the technical and scientific skills required to build businesses required in the innovation economy.
b. Startup Visa. Proposed legislation described as a "Startup Visa" to provide a mechanism for foreign individuals starting qualified businesses in the United States to remain here so long as they meet certain pre-set criteria. This legislation will encourage investment in foreign talent intending to build businesses in the U.S. that increase jobs and build long-term economic value.

While I recognize immigration reform is outside the scope of this specific hearing, I believe talent is one of the most important resources required for building a successful business. America continues to serve as a location where individuals from the world-over hope to come and participate in the entrepreneurial ecosystem. We should leverage this fact to help support existing businesses as well as new businesses that can or will be formed by these foreign entrepreneurs.

**Conclusion**

In conclusion, I want express my sincere gratitude to Chairman Issa, Ranking Member Cummings, and each of the members of the Committee for your time today. I am passionate about the entrepreneurial ecosystem as a member of the ecosystem and as a concerned citizen. The opportunity to assemble a panel of outstanding thought-leaders to discuss how to spur job growth, increase innovation and increase competitiveness is a crucial point of discussion.

I'd also like to thank the SEC and fellow George Washington University Law School Alum Chair Schapiro for her time today, and for the Commission's consideration of these rule changes. Each of us wants to find ways to spur job creation, innovation and global competitiveness. And such changes require a balanced approach. However, I believe that some simple changes can return us to balance between investor protection and spurring innovation. We must remodel outdated rules and regulations to spur the creation of and investment into today's small businesses and startups that will be tomorrow's economic "anchor tenants."

Thank you.

Chairman ISSA. Thank you. Dr. Rahn.

**STATEMENT OF RICHARD W. RAHN**

Mr. RAHN. Mr. Chairman, ranking member, and other members of the committee, thank you very much for inviting me to be with you here today.

I want to take a different tack. I want to challenge the conventional wisdom. We have a regulatory structure of the SEC which was basically designed in the 1930's, and the question is, is that really appropriate for today's Information Age?

If you had to start over again, let's assume we had no SEC, how would you design it? Would you create one? Would it look anything like the SEC we have today?

There has been a lot of evidence that the SEC is somewhat dysfunctional. We've been losing global market share, we've had the debate about the IPOs and how much that is—the reduction of IPOs is due to the SEC and so forth.

One thing strikes me. A huge portion of the SEC budget goes into enforcement. If the other divisions of the SEC were doing their job, it would seem that we would have very few enforcement needs. And is this really the way we want to go. There's a theory in economics, there's a whole public choice school of economics that looks at the motivations of people within bureaucracies. In the whole area of cost-benefit analysis I think is an undermanaged activity within the SEC. We have a basic conflict. The SEC is an agency primarily driven by lawyers, relatively few economists. And as an economist, I have a certain bias here. But when I have been on a board of a regulatory agency, and I have seen the problem, that the regulators of course keep their jobs by coming up with more regulations and rules. I'm not saying they are of evil intent but it's just the nature of the way people operate, and the job of really the chief economist role is to say no to rules that aren't justified. But they have to really be independent from the rest of the staff in order to do an objective job.

We don't see it at the SEC or most other government regulatory agencies, and I think we have to rethink the whole structural model of how we set these agencies up, in particular the SEC, to give more balance to really looking at the costs and benefits of every possible regulation, every piece of paper, everything that comes out.

One example is the whole area of accredited investor. This started off with the perfectly good intent of trying to keep the—allowing people who should be able to take care of themselves to be in without having to be regulated. But we look at what has happened. Right now, we only have about 2 percent of the U.S. population that qualifies as an accredited investor. Does this make any sense? You can have a rock musician or a sports figure who meets the income and net worth standards, but a young tax attorney or professor of finance doesn't. Does that make sense?

I don't think we ought to have a system where we say only 2 percent of the population is so-called smart enough to be able to be accredited investors. We ought to have at least 50 percent of the population, or I think a lot more. Most people can make judgments. People make mistakes. We find even the richest and most sophisticated make mistakes. We all make mistakes. But that doesn't mean the government ought to prohibit us from having the opportunities that only the wealthiest among us have.

Insider trading, everybody has been against insider trading. It seems logical to oppose insider trading. But there's a lot of new academic evidence, scholars, law and economic scholars, who have studied it and say no, this is actually causing us more problems. We get into the whole area of what I call vague law with insider trading. The SEC brings many insider trading actions, but they're unsuccessful in the vast majority of these. And part is because we can't even define insider trading. And so I argue that we really need to go back to square one here, think of how we set up these organizations to truly protect investors and not get hung up with the things that we've done in the past which may not be sensible.

Thank you very much. I do appreciate the opportunity to be here with you today. Thank you.

[The prepared statement of Mr. Rahn follows:]

**Testimony**

**of**

**Richard W. Rahn, Ph.D.**

**"The Future of Capital Formation"**

**before**

**the Committee on Oversight and Government Reform**

**House of Representatives**

**Congress of the United States of America**

**Washington, District of Columbia**

**May 10, 2011**

Mr. Chairman and Members of the Committee:

Thank you for inviting me to testify today on the important subject of capital formation and SEC regulation. I am Richard W. Rahn, a Senior Fellow at the Cato Institute and a syndicated weekly economic columnist. My testimony today reflects my own opinions and views and not necessarily those of any organization with which I have an affiliation.

Over the last few decades, I have served as head of a graduate school of business, a professor of economics, executive director of the American Council for Capital Formation, Vice President and Chief Economist of the U.S. Chamber of Commerce, an economic advisor to political leaders in a number of countries, including the U.S., and as a financial regulator. In addition, I have been an entrepreneur and raised capital for several start-up companies, one of which, Sterling Semiconductor, was sold to a publicly-held company.

In my view, the Securities and Exchange Commission is in need of a drastic restructuring and downsizing, because it has done considerable damage to the U.S. economy:

- There were a total of 3,784 IPOs from 1980 to 1989, 5,598 IPOs from 1990 to 1999, and only 1,650 IPOs from 2000 to 2009. This drastic decline is in part explained by the additional regulatory burdens and costs the SEC has placed on those trying to go public. At the same time, foreign jurisdictions are gaining IPO market share. The number of IPOs is a rough proxy for the entrepreneurial climate in a country.

- The number of listed companies on major U.S. exchanges is a little more than half of what it was 15 years ago. The U.S. has also been losing global financial services' market share. Much of this decline is a direct result of the increasing cost of maintaining a public listed corporation and conducting financial businesses in the U.S.

- The U.S. share of world GDP has fallen from roughly a quarter a decade ago to less than one-fifth today. Part of the reason for the relative decline of the U.S. share is the excessive regulation U.S. companies are suffering, and some significant part of this unnecessary regulation comes from the SEC.

In the meantime, the SEC's budget has exploded, increasing an extraordinary five-fold in the past 15 years, with no objective indication that investors or financial markets are more protected or improved. Countries compete not only in the production of goods and services but also in regulatory efficiency, and by this measure the SEC should receive a failing grade.

In sum, the SEC has provided *negative* value added. If the SEC was a private company with this kind of track record, it would have long since gone out of business.

A major problem with the SEC is that it does not do proper cost-benefit analysis for both new and existing regulations. Many outside observers, who are familiar with what the SEC calls cost-benefit analysis, view it as joke in that it often is not up to professional standards. This is not surprising given the inherent conflict of interest within the SEC. Those who are hired to write regulations know that if they ever say they have written all of the regulations that really need to be written, they will no longer be needed; hence, no job.

The currency among those in government is not so much money as it is power, number of staff, and visibility. Thus, the people at the SEC, from the Chairman on down, have an incentive to grow the agency and get it into new areas – whether needed or not – in order to justify more staff and a bigger budget. There is an entire field in economics, known as "public choice," which is devoted to the study of the problem of those in government having different goals from those of the citizens they are supposed to be serving. The office responsible for doing cost-benefit analysis will not be considered a "team player" if it does approve most new regulations. A conflict of interest exists as long as those doing cost-benefit analysis report to those who have an interest in making the agency bigger. A partial solution to this problem is to make the office of the chief economist separate from the existing organization, much like the offices of the various "inspector generals" in government departments. One of the jobs of the office of the chief economist is to say "no," which requires independence.

In this testimony, I will give examples of the problems caused by inadequate cost-benefit analysis. I shall start with a personal example. I was one of the founders of a start-up semiconductor company. We grew rapidly, required more capital, and were faced with a choice of selling a major share of the company to a venture capital group, selling the company to a publicly-listed company, or doing an IPO. Our preferred solution was an IPO because we viewed that as the best alternative to maximize existing shareholders' value. However, once we had evaluated the cost of going public – much of it due to excessive SEC regulations – we had to settle for second best, which was a sale to a publicly-owned, listed company. This turned out to be an inferior solution that denied our initial investors much of the upside potential that they may have obtained with an IPO. SEC's overregulation did not protect our initial investors, but cost them dearly. Such overregulation, requiring excessive time by accountants, lawyers, and others, diverts needed capital away from new enterprises which have the most potential to create jobs and increase productivity.

Another example of SEC overreach is in the whole area of "accredited investors." The concept of the "accredited investor" was originally created as a "safe harbor" for those seeking investments in new or small enterprises, and not as a restriction on other perfectly suitable investors. The SEC took this constructive concept and turned it into a minimum requirement by making the registration process so expensive that small companies have almost no choice but to restrict themselves to only soliciting "accredited investors." By requiring minimum net worth and income standards for investors in start-ups, etc., the SEC now prohibits perfectly suitable potential investors from enjoying the profits of new and small companies. These standards appear to be totally arbitrary and rule out all but a couple of percentage of the entire population. Under the existing SEC definitions of an "accredited investor," a rock musician or football player with a high income and net worth but no knowledge about investments is "accredited."

On the other hand, a young professor of finance or tax lawyer who has not yet met the income and net worth requirements is not allowed to invest. This policy is "stupid," destructive, and discriminatory. Wealthy people are allowed to invest in things that can make them much more money, but poorer people (98%+ of the population) are prevented from the same opportunity.

The SEC's rationale for this destructive, discriminatory policy is to protect the less sophisticated investors from a potential loss. If it is really considered public policy to protect people from decisions causing financial loss, why does not government require everyone who gambles in Las Vegas, Atlantic City or wherever to become an "accredited gambler." When one studies the mathematics of probability, one learns that even in a fair game (with even odds) eventually it does not matter how much money a player has; he or she will lose it all; this is known as "the gambler's ruin theorem." Casino gambling is not a "fair game" in that the house must have its "take." It even gets worse with the state lotteries, which often give terrible odds (if they are not financial fraud, I don't know what is). Yet, anyone, no matter how poor or incompetent, is allowed, and often even encouraged by government, to gamble his or her entire net worth and then some.

Unlike gambling, including state lotteries, we know that most people who invest in the stock market make money over the long run. There are already plenty of statutes on the books to punish misrepresentation and fraud by stock promoters and boiler shop operators; and so the "accredited investor" concept is just not needed, and, in fact, it has now become destructive. It would be interesting to know how many people who were prohibited from investing in start-up companies instead gambled away part of the money. In sum, the SEC is engaged in an activity that reduces productive capital formation and denies most people the opportunity to improve their well being, which has the side effect of encouraging people to engage in irrational and destructive gambling. If the SEC had a serious and independent office for doing cost-benefit analysis, the existing "accredited investor" nonsense would have been deep-sixed many years ago. In a free society, people should be free to spend and invest their money as they see fit, and for the nannies at the SEC to pretend they know better is nothing more than what the great economist and Nobel laureate F. A. Hayek referred to as the "fatal conceit."

It has long been an article of faith at the SEC that trading on "inside information" is evil and must be stopped at all costs. This has led the SEC to create broader and broader definitions of both what is "inside information" and who is an "insider." The war on insider trading has much intuitive appeal; but like many things that seem obvious, it just does not stand up under rigorous analysis. The esteemed law and economics scholar Henry Manne wrote a classic book on the subject back in 1966 where he challenged the conventional wisdom on insider trading by observing that the attempts to stop insider trading had adverse effects on price discovery, thus disadvantaging investors who were not insiders. Over the years, more and more law and economics scholars have come to understand that Manne was correct. In recent years, Manne (who is dean emeritus of the George Mason University Law School) has continued to make his case, which is now increasingly obvious, of the almost impossibility of containing information in the age of instant information everywhere. To think that valuable information about relevant matters within a corporation is not going to leak out deliberately or accidently is the ultimate naivety. Here we have the SEC demanding that companies keep secrets from their investors and the outside world until the time when the SEC suddenly declares that now is the moment it can be released. Does this not contradict the self-proclaimed goals of openness and transparency?

The U.S. government cannot keep its most sensitive military and diplomatic secrets from leaking out, yet it expects thousand of companies with less sensitive information to keep it from leaking. Company officers and directors can be fined or go to jail for a mere momentary slip of the tongue or lapse in judgment. Yet, how often do we see high-level government officials go to jail or pay fines for far more serious breaches? Never!

The SEC continues to try to stretch the definition of an insider, even attempting to go after securities' analysts whose job it is to ferret out information in order to serve investors. The Supreme Court in the Dirks case made it clear that, in the absence of a fiduciary duty to keep information secret, the law favors a free flow of information to the market. Yet, the SEC continues to ignore the Dirks case in its never-ending zeal to restrict free speech and legitimate information flow. The 1st Amendment's protection of free speech should always trump demands by regulatory bureaucrats for more speech restrictions. This is particularly true since Manne and others have shown that the SEC's information restrictions actually impede price discovery and hence deny investors the information they need to both protect and benefit themselves.

What is valuable to me as an investor is to know if the officers and directors of a company are buying or selling shares. With modern technology, this could be available to me within a few seconds of an "insider" buying or selling, allowing me to act on this information. Instant information on insider sale or purchases is likely to be much more useful to an investor than some long-held, sterilized press release overseen by those at the SEC about what they consider to be a change in the material condition of a firm. When I buy stock, I understand that those within the company are going to have more information than I do and will have an advantage over me – and that is the nature of life. To assume that a regulatory agency can somehow ensure that all investors have all of the relevant information, with the same level of understanding, at the same time is utopian non-sense and again evidence of the "fatal conceit."

Trying to define an "insider" is an almost impossible task. During this past year, there were press stories about how a number of Senators appeared to have consistently made outside returns in their investment portfolios, and the implication was that they had information the rest of us did not have in making their investment decisions. I expect that was both true and not-illegal. Members of Congress make decisions all of the time that materially affect companies and, as a result, stock prices. An intention to place a costly regulation or tax on an industry or company, or give an industry or company a subsidy before it is announced to the public provides a perfect selling or buying opportunity for those members of Congress and their staffs in the know. There are many people in Washington who make their livings by trying to ferret out the intentions of the elected representatives.

As a result, there have been calls to place trading or other restrictions on members of Congress and their staffs. In my view, such restrictions would be largely unenforceable and counterproductive because there are too many ways to get around them; and with human nature being what it is, ways would be found to circumvent any restriction. Members could give a wink and a nod to key campaign contributors about intended actions to benefit or hurt particular companies. As a practical matter, it is not possible to prevent members of Congress, their staffs, their families, and their contributors, etc. from having prior information which will hurt or benefit companies. And having such prior information provides such an incentive to act upon it that some will. This may not necessarily be bad, because, to the extent such actions affect the stock price, non-inside investors will then obtain information that may influence their own buy and sell decisions.

If it is impossible to control what members of Congress will do or say, even though it may have a major impact on companies, why should only employees of companies and their relatives, friends, etc. be subject to insider trading restrictions? To penalize what should be the right of free speech by corporate executives, and not penalizing the similar speech of others in the know which may be even more damaging or beneficial to a corporation is both hypocritical and grossly unfair. There have been all too many cases of rogue prosecutors and regulators – some even from the SEC - making untrue charges (which were later thrown out of court) about companies and their executives that greatly and unfairly damaged investors. Corporate officers are subject to prosecution for making untruthful statements that hurt investors. Perhaps, investors who have suffered losses by untruthful statements or regulatory excesses by SEC personnel should be allowed to recover their losses from these miscreants in the same way that corporate executives are fined. This would encourage SEC personnel to be more responsible. The SEC and too many other agencies have abused the privilege of sovereign for far too long.

The SEC has almost completely ignored the arguments of many law and economics scholars in regard to insider trading. It has ignored the mile wide loop holes in its regulations, as noted above. It has failed to do adequate cost-benefit analysis. And it has failed to recognize the hypocrisies and practical unenforceability of its own rules in regard to insider-trading.

Again, public choice theory explains the behavior of the SEC in regard to insider trading regulations. If there are few restrictions, and if these restrictions are clear and enforceable, only a few people will be necessary to enforce them; hence, a smaller agency. Congress is going to have to force the SEC to make these necessary changes because the agency will never make them on its own because it does not think the changes are in its self-interest.

I have only touched on a few of the issues where the SEC needs to be radically restructured and downsized. The SEC has strayed far from its core mission, allowing Madoff, Enron, and others to completely elude the agency, while the SEC has chased never-ending new missions. The SEC does not need more staff and budget to do its job. The problem is that its staff and budget have grown so large and the agency is so-dysfunctional it is no longer doing its core job. The SEC has become a major drag on the economy by increasing uncertainty and risk for businesses, and by saddling businesses with costly and non-productive regulations.

The current budget crisis should be used as an opportunity to force the SEC to downsize and restructure. Companies that get into trouble are forced, at times, to lay off many of their staff in order to both survive and prosper.

Congress should say to the SEC:

> "You have failed to do adequate cost-benefit analysis so we will no longer give you the funds to enforce regulations that have not or do not pass a rigorous independent cost-benefit test. The overregulation has reduced productive capital inflow to the corporate sector, hurting productivity growth and job creation.
>
> You have in effect denied 98%+ of the population the opportunity to participate in new ventures without excessive cost. This has driven needed productive capital out of start-up companies. Thus, we will no longer fund the enforcement of the existing "accredited investor" restrictions. Investors will continue to be protected by laws and rules against misrepresentation and fraud.
>
> Your insider-trading rules are inconsistent and in many ways destructive, so we will not provide you with the funds necessary to enforce these rules until you develop satisfactory alternatives, which are both economically sound and legally enforceable without trampling on basic Constitutional rights of the citizens."

Thank you very much.

Mr. McHENRY [presiding]. Thank you, Dr. Rahn.
And Mr. Macey.

**STATEMENT OF JONATHAN R. MACEY**

Mr. MACEY. Thank you. It's a great pleasure to be here and I enjoyed very much listening to the questions and the answers, particularly the questions in the first panel which I felt were extremely well informed, and I wanted to elaborate on some of the points that were made in light of my own views of some of the issues that are facing us in terms of capital formation.

First, we have two competing sets of statistics with regard to initial public offerings in the United States, and I want to make it clear that both of these sets of statistics are interesting and important and accurate.

One set of statistics, introduced by the chairman, is the idea that the number of U.S. public offerings over the last 20 years has been in decline. That statistic becomes more interesting, I think, it's an interesting statistic, it becomes even more interesting in light of the article from the Atlantic Monthly that the ranking minority member mentioned that says that while the number of initial public offerings may be going down, the amount of money raised in public offerings, not just the number of deals, but the actual amount of money has been going up.

What that means, of course, is that because both of these sets of statistics are accurate is that we've had fewer public offerings, but each of the public offerings that we've had has been raising on average more money than investors have in the past. What this means, I think uncontrovertibly, is that the capital formation process has come to be dominated by only the very largest issuers; that is to say, with respect to the statistics in the Atlantic about the amount of money raised in public offerings, one offering of $500 million counts exactly the same as 100 offerings of $5 million. And I think this raises an extremely important point about the disproportionate impact of the regulations that we have.

Regulations have benefits and they have costs. The benefits are generally the same for all investors and all firms. The costs, however, fall disproportionately on small and medium sized firms because they take the form of fixed costs, so the relative burden on a very large company of going public hasn't gone up very much, but the burden on small and medium sized companies has gone up quite a bit. And really if you compare the industrial structure of the United States with respect to job formation, with respect to diversity, both in terms of product lines and in terms of technology and in terms of geography across the country, the real strength of the U.S. economy has been that we have a very large number of small and medium sized firms and relative to European economies and Asian economies, our economy is much better, the firms in our economy are much better distributed between small, medium and large firms rather than having, as we see in other countries, no middle sized firms, or very few, and firms disproportionately collected at the small and the large end of the continuum. And I think that it would be very useful in thinking about the reform of these SEC rules, particularly the 500 shareholder ban and the general solicitation ban, to think about the disproportionate impact of these rules on small and medium sized companies and to think about the idea that in terms of job creation we really do not only want to encourage the total amount of money raised in public offerings, but we also want to increase the number of companies, the number of entrepreneurs, the number of businesses that have access to the capital markets.

So with that, I will spend my last minute talking about a couple of specific things, one the general solicitation ban and the 500 shareholder ban.

I don't think that either of these provisions help small or medium sized businesses. I don't think either of these provisions protects investors. I also want to point out as a factual matter that the SEC's justification for the general solicitation ban has changed quite a bit over time. Now it is some idea that we need to protect investors. It used to be, the original justification for the general solicitation ban was that we needed to stop investors from becoming too enthusiastic about securities offerings, that if we allowed a general offering to take place then there would be a kind of a consumer frenzy that would occur.

So thank you very much for this time. I appreciate it.

[The prepared statement of Mr. Macey follows:]

Testimony on
"The Future of Capital Formation"

Testimony by

Jonathan R. Macey,

Sam Harris Professor of Corporate Law, Securities Law and Corporate Finance, Yale Law School; Professor, Yale School of Management

Before the

112th Congress of the United States, House or Representatives' Committee on Oversight and Governmental Reform

Tuesday, May 10, 2011

First, I would to express my gratitude to United States Congressman Darrell Issa and to his staff and his colleagues on the Committee on Oversight and Governmental Reform for recognizing that capital formation is becoming an acute problem in the United States.

This troubling issue is vital to the future of our economy as well as to the future of every economy in the world. As the world progresses and new business strategies and new commercial technologies emerge, the very heavy demands placed on the efficiency of the U.S. capital formation process are only going to become more challenging in the future.

In my view, the SEC is a failed regulatory agency. Its failure, however, unlike the failure of some governmental bureaucracies is not mostly attributable to incompetence or corruption. Some evidence of incompetence can be found in the SEC's bi-partisan decision to allow large investment banks to assume titanic amounts of leverage just before the market collapsed in 2007 and 2008. Additional problems are in evidence in the SEC's alarming failure to heed whistleblowers who were raising alarms about Bernie Madoff power scheme.

It simply is the case that mistakes sometimes happen. The hard truth is that it simply does not appear to be the case that the Securities and Commission and its staff are *significantly* more incompetent or corrupt than other governmental agencies. Rather, the SEC's problems are structural and cultural. I think that there are the following five such structural and cultural problems:

1. No Clearly Defined or Attainable Goals
2. No Clearly Identifiable Clientele; The SEC Often Helps Big Fish Sue Other Big Fish
3. The SEC is Living In The Past and Cannot Understand How Modern World
4. The SEC's Perverse Incentives
5. The SEC's is not Knowledgeable About Economics of Its Own Regulation

**1. No Clearly Defined or Attainable Goals**

In order to succeed at something, one must have some sort of concrete goal worth attaining. The SEC itself claims that "mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." http://www.sec.gov/about/whatwedo.shtml . But how does one know whether the SEC has succeeded or failed?

**2. No Clearly Identifiable Clientele; The SEC Often Helps Big Fish Sue Other Big Fish**

The SEC does not have a place for the small investor in its game plan. In the most famous SEC enforcement action of 2010, the SEC sued Goldman Sachs and its star trader Fabrice Tourre for "making materially misleading statements and omissions in connection with a synthetic collateralized debt obligation ("CDO") GS&Co structured and marketed to investors." But what investors were these? THE Complaint is conmpletely silent on this until page 15 of its 22 pages. Then the injured parties are: (1) IKB Deutsche Industriebank AG ("IKB") a commercial bank headquartered in Dusseldorf, Germany; (2) by ABN AMRO Bank N.V. ("ABN"), which was one of the largest banks in Europe. Why are U.S. taxpayers paying billions in taxes to have the SEC referee disputes among the world's largest banks that these banks easily could handle among themselves? The SEC claims to be trying to benefit small investors, but it has no coherent theory of what role, if any, small investors are supposed to play in capital markets. For one thing, if small investors are going to participate in stock markets, then they are going to lose money and the SEC seems to think that risk is unacceptable, even in the face of full disclosure by companies that are widely known and admired. On January 18, 2011, fears of SEC lawsuits and possible criminal prosecution caused Goldman Sachs to abandon its lan to privately sell as much as $1.5 billion in Facebook Inc. shares to wealthy U.S. Instead all of the Facebook shares were offered and sold only to foreign investors. Why? Because the SEC's strict rules on private placements are designed not only to prevent investors from buying; they also are designed to prevent investors from becoming unduly interested in or enthusiastic about new investment opportunites.

**3. The SEC is Living In The Past and Cannot Understand How Modern World**

Remember the world as it existed when the SEC was formed and for much of the SEC's history. When the SEC was formed there were few, if any international capital markets, this means that the SEC had monopoly regulatory power and U.S. companies and stock exchanges had no choice but to comply with any and all rules promulgated by the Commission.

The SEC evolved to its present form during the Great Depression and the post-World War II period of reconstruction. By the end of World War II, the capital markets of Asia and Europe had been destroyed. The goal of the United States was to rebuild the devastated European continent and to make Europe and Asia prosperous again. In addition to the massive contributions to Western Europe under the Marshall Plan, the U.S. provided billions of dollars in grants and credits to Asian countries including China, India, Indonesia, Japan, South Korea, Pakistan, the Philippines and Taiwan In other words, when the SEC was developing its *modus operandi* the global capital markets that dominate the planet in 2011 simply did not exist. The U.S. was the only capital markets regulator in the world that mattered, and the U.S. were the only capital markets in the world that mattered. This, fortunately, is no longer the case. Unfortunately, the SEC does not seem to have realized that it is no longer the only cop on the beat and that a growing number of honest civilians prefer to operate under less arrogant and intrusive supervisory regimes.

In other words, the SEC needs finally to make a clean break with the past.

**4. The SEC's Perverse Incentives**

A major factor that influences the SEC's conduct is the metamorphosis of the SEC from an administrative agency dominated by industry experts, economists and lawyers into an agency dominated exclusively by lawyers.[1] This metamorphosis has affected the culture of the SEC profoundly. In particular, the glacial speed at which the SEC operates is largely attributable to the Commission's lawyer-dominated culture. In addition to slowing things down, the SEC's domination by lawyers has affected the Commission in another way. There has long been a

[1] Troy A. Paredes, "Remarks Before the Mutual Fund Directors Forum Ninth Annual Policy Conference," May 4, 2009, available at www.sec.gov/news/speech/2009/spch050409tap.htm, accessed October 18, 2009.

revolving door connecting the SEC with Wall Street. But now SEC staffers are focused on maximizing their reputations within the legal culture rather than more broadly among economists and business people as well as lawyers. For example, the people heading the Enforcement Division of the SEC in recent years all have moved to jobs as advisers to banks. The most recent Director is now a partner at Davis, Polk & Wardwell. Her predecessor is the general counsel at JPMorgan Chase. His predecessor became general counsel at Deutschebank. Others in recent years have gone to Credit Suisse and Morgan Stanley. One "could be forgiven for thinking that the whole point of landing a job as the SEC's Director of Enforcement is to position oneself for the better paying one on Wall Street."[2]

Finally, the SEC has strong incentives to promote the appearance that the capital markets are in crisis and to eschew the development of market mechanisms that might solve the very problems that the SEC is tasked with solving. As long as it generally is viewed that the SEC is needed in times of crisis, and that there are no superior substitutes for the particular sort of crisis intervention done by the SEC then there will be a need for the Commission. And ironically, the more financial crises there are, the more the SEC can claim that it needs greater resources to meet such crises.

It appears clear that the SEC is largely evaluated on the basis of how well its Division of Enforcement performs. The SEC is divided into five divisions. Four of these are rather obscure and have not attracted much controversy. These four are: (1) the Division of Corporate Finance, which reviews SEC registration statements: (2) the Division of Trading and Markets, which pursues the SEC's mandate for maintaining fair, orderly and efficient markets; (3) the Division of Investment Management, which is supposed to protect individual investors by overseeing and

[2] Michael Lewis and David Einhorn, "The End of the Financial as We Know It," January 4, 2009, The New York Times, www.nytimes.com/2009/01/04/opinion/04lewiseinhornhtml (accessed October 18, 2009).

regulating the $26 trillion investment management industry; and (4) the Division of Risk, Strategy and Financial Innovation, which was established in 2009, "to help further identify developing risks and trends in the financial markets" by "providing the Commission with sophisticated analysis that integrates economic financial and legal disciplines."[3]

The principal SEC division is the Division of Enforcement. The SEC describes itself as follows: "first and foremost, the SEC is a law enforcement agency."[4] The Division of Enforcement exists to enable the Commission to investigate possible securities law violations. The SEC is supposed to investigate possible violations of the securities laws, and where appropriate, to recommend to the Commission that a civil action be brought against individuals and companies that have violated such laws. Upon obtaining the necessary approval from the Commission, the Division of Enforcement then prosecutes on behalf of the Commission the cases it has investigated.[5] An additional component of the Division of Enforcement mandate is to work closely with law enforcement agencies in the U.S. and around the world to bring criminal cases when appropriate. In the U.S. this is done through a referral process subject to which the SEC refers cases to the Criminal Division of the U.S. Department of Justice and then works with the Assistant U.S. Attorneys in the DoJ in bringing criminal actions.

At the SEC "enforcement actions have traditionally defined the mission of the agency."[6] In fact, the economic sociologist William Bealing has posited, correctly in my view, that it is the activities of the Enforcement Division of the SEC that legitimize the Commission's 's existence

[3] Securities and Exchange Commission: "The Organization of the SEC," available at http://sec.gov/about/whatwedo.shtml accessed October 17, 2009.
[4] *Id.*
[5] *Id.*
[6] John Sivolella, "Bureaucratic Decision Making – SEC Enforcement and the Federal Courts' Ideology" paper delivered at Midwest Political Science Association conference, April, 2007l available at http://www.allacademic.com//meta/p_mla_apa_research_citation/1/9/6/8/4/pages196843/p196843-1.php.

and its federal budget allocation to Congress.[7] And it certainly appears that "the SEC is carrying out its (enforcement) duties so as to maintain a base of support within the Congressional budget process."[8]

Assuming that the SEC is deeply concerned with its budget and that the performance of the enforcement division is critical to the SEC's success, it is my claim that the strategy that the SEC employs to maximize its appeal to Congress and more generally to maximize the overall notion that the Commission is effectively employing the resources that Congress has allocated to it is to emphasize focus on available, salient criteria.In particular the SEC focuses on the raw number of cases that it brings and on the sheer size of the fines that it collects. For example, when criticized recently for failing to respond to numerous tips from whistle-blowers and red flags in the case of Bernard Madoff's massive fraud, the SEC noted in Congressional testimony that: "comparing the period from late January to the present to the same period in 2008, Enforcement has: opened more investigations (1377 compared to 1290); issued more than twice as many formal orders of investigation (335 compared to 143); filed more than twice as many emergency temporary restraining orders (57 compared to 25); and filed more actions overall (458 compared to 359).[9]

The SEC's 2008 Annual Report's is similarly clear in its emphasis on the easily measurable criteria of number of enforcement actions brought and the amount of fines assessed in such actions:

> During 2008, the SEC completed the highest number of enforcement investigations ever, brought the highest number of

[7] Bealing, William E., Jr. 1994. "Actions Speak Louder than Words: An Institutional Perspective on the Securities and Exchange Commission." Accounting,Organizations and Society 19(7):555-567.
[8] Sovilella, *supra*, at page 30.
[9] Robert Khuzami and John Walsh, "Testimony Concerning the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance," September 10, 2009, available at http://www.sec.gov/news/testimony/2009/ts091009rk-jw.htm, accessed October 19, 2009.

> insider trading cases in the agency's history, and brought a record number of enforcement actions against market manipulation—including a precedent-setting case against a Wall Street short seller for intentionally spreading false rumors. The SEC in 2008 also initiated the second-highest number of enforcement actions in Commission history.
>
> During each of the last two years, the SEC set the record for the highest number of corporate penalty cases in agency history. For the second year in a row, the Commission returned more than $1 billion to harmed investors using our Fair Funds authority under the Sarbanes-Oxley Act. To support this record level of law enforcement activity, more than one-third of the SEC staffs now serve in the enforcement program. That is a higher percentage of the SEC's total resources than at any time in the past 20 years.
>
> The SEC devoted more funds to enforcement in 2008 than at any time in agency history. In 2008, the number of enforcement personnel grew by 4 percent. [10]

The SEC's 2008 Annual Report was written at a juncture in the SEC's history when the Commission's reputation was under severe stress. Three events in particular, the collapse of Enron, the emergence of regulatory competition from state attorneys general, particularly Eliot Spitzer, and the SEC's incompetence in its handling of the $50 million securities fraud orchestrated by Bernard Madoff, which resulted in his arrest on December 11, 2008,11 tarnished the SEC's traditional standing as America's foremost administrative agency in terms of quality and integrity. The SEC has been buffeted in recent years and it is difficult to imagine that the Commission's position at the center of a political maelstrom has not affected the agency's behavior. The ruling makes salient "a long-standing criticism that the S.E.C. has largely failed

[10] http://sec.gov/2008annual/SEC_2008annual_trustp2.htm
[11] http://online.wsj.com/article/SB124605921584963599.html?mg=com-wsj

to prosecute cases against corporate executives, opting for quick settlements in which companies themselves are penalized instead of their leaders."[12]

In my view it is the SEC rationally has pursued a policy of opting for quick settlements because the SEC is largely judged on the basis of the number of cases it wins. The needs fewer resources to sue companies than individuals because companies don't defend themselves as vigorously as individuals do). In addition, the SEC has moved to a policy of suing and settling with industry groups.

The SEC in recent years has pursued policies of attempting to expand the contours of the law (which makes it easier for them to bring cases), of keeping the law vague (refusing to define insider trading). Finally and most importantly the SEC has pursued a policy that is consistent with the Commission's rational self-interest but clearly suboptimal from a societal perspective, of economizing on doing investigations. Investigations are costly and

In particular, the SEC's enforcement effort is evaluated in overly-simplistic ways. The focus is on the number of cases brought by the Division, and, to a lesser extent, on the size of the fines collected by the SEC. The more cases that are brought and the greater the amount of fines collected during a particular time frame, the better the enforcement staff at the SEC is thought to perform. This has long been the case, but the problem got worse as a result of the political challenge that the SEC has faced from politically opportunistic state attorneys general, particularly Eliot Spitzer.

Rather, I will argue that the root cause of the problem is the peculiar way that the performance of the Enforcement Division is evaluated, both by the general public and by elected officials.

[12] NY Times September 15, 2009 Zachery Kouwe, Judge Rejects Settlement Over Merrill Bonuses available at http://www.nytimes.com/2009/09/15/business/15bank.html?ref=business.

In light of this metric of success, it is not surprising that the SEC focuses on low hanging fruit: investigations take time. So the SEC focuses on bringing cases that do not require much, if any, investigative effort. Indeed, the SEC makes no secret of the fact that it does virtually no detective work. It derives its docket of cases from scandals that are reported in the press and from tips from whistleblowers. Indeed, as Maureen O'Hara and I have argued in other work, the SEC often does not even pay attention when evidence of fraud appears in well-known scholarly journals in corporate finance. Enforcement comes only after an issue is made politically salient by the financial press. Similarly, the pressure to bring lots of cases explains why the SEC tries to broaden the scope of the law and why it rushes to settle cases.

A major theme of this Article is that the performance-based incentives to which even the most able bureaucrats respond are perverse and lead to perverse results.

The number of enforcement actions and the size of the fines that the SEC may not be the best criteria by which to evaluate the conduct of the SEC, but they are data that are "available," as that term is understood in social psychology and behavioral finance. Something is available in this context when it can be easily recalled from memory or readily available sources. The availability heuristic is one of the most widely shared assumptions in decision making as well as in social judgment research. [13] The availability heuristic posits that people tend to use evaluative techniques on the basis of "the ease with which instances or associations come to mind." [14]

[13] Norbert Schwarz, Herbert Bless, Fritz Stack, Gisela Klumpp, Helga Rittenauer-Schatka, and Annette Simons et al., "Ease of Retrieval as Information: Another Look at the Availability Heuristic," 61 Journal of Personality and Social Psychology, 195-202 (1991).

[14] Aaron Tversky & Daniel Kahneman, (1973). Availability: A heuristic for judging frequency and probability.5 Cognitive Psychology, 207-232, 208 (1973).

Thus, the apparent focus by the SEC (and Congress and the public) on how many cases the SEC brings and on the size of the fines collected appear to represent the availability heuristic in action. And, as in other contexts, this reliance on availability leads to predictable biases. In other words, it is my view that the SEC's apparently odd behavior in recent years is not due to corruption or incompetence on the part of the agency. Rather, the SEC simply has been responding, more or less rationally, to the rather odd set of incentives that it faces from its overseers in Congress and from the general public.

In addition to its focus on the number of cases that it brings and on the size of the fines it collects, another factor that influences the SEC conduct is the dominance of lawyers within the agency. [15] The consequences of this domination include increased concern with process and decreased concerns with social science evidence in decision-making. In addition, because lawyers are less knowledgeable about how the financial markets operate than are actual participants in the industry, the rise of a lawyer-dominated culture at the SEC has resulted in a diminution in in-house technical expertise and in less understanding about the nuts and bolts of complex financial instruments and the operation of financial markets during an era in which complexity has been increasing rapidly.

The glacial speed at which the SEC operates is largely attributable to the Commission's lawyer-dominated culture. Consistent with the view expressed here, Harry Markopolos, the industry whistle-blower who tried, unsuccessfully, to bring the SEC's attention to Bernie Madoff's Ponzi scheme has described the the SEC as "too slow" and observed that the Commission ",was hindered by lawyers, did not understand red flags, could not do the math and was captive to the financial industry." Mr. Markopolos also testified that "the SEC staff lacks

[15] Troy A. Paredes, "Remarks Before the Mutual Fund Directors Forum Ninth Annual Policy Conference," May 4, 2009, available at www.sec.gov/news/speech/2009/spch050409tap.htm, accessed October 18, 2009.

the financial expertise and is incapable of understanding the complex financial instruments being traded in the 21st century," and that "the SEC is overlawyered and has few too staff with relevant industry experience and professional credentials to find fraud even when a multi-billion dollar case is handed to them on a silver platter."[16]

In addition to slowing things down, the SEC's domination by lawyers has affected the Commission in another way. There has long been a revolving door connecting the SEC with Wall Street. But now SEC staffers are focused on maximizing their reputations within the legal culture rather than more broadly among economists and business people as well as lawyers. For example, the people heading the Enforcement Division of the SEC in recent years all have moved to jobs as advisers to banks. The most recent Director is now a partner at Davis, Polk & Wardwell. Her predecessor is the general counsel at JPMorgan Chase. His predecessor became general counsel at Deutschebank. Others in recent years have gone to Credit Suisse and Morgan Stanley. One "could be forgiven for thinking that the whole point of landing a job as the SEC's Director of Enforcement is to position oneself for the better paying one (as a lawyer) on Wall Street."[17]

The available empirical evidence supports the conclusion that SEC lawyers have significant mobility. The turnover rate for SEC attorneys is almost twice as high as the turnover rate for all government attorneys.[18]

Finally, the SEC has strong incentives to promote the appearance that the capital markets

[16] Markopolos Congressional testimony quoted at http://www.wkrg.com/politics/article/fraud_investigator_blasts_sec/23318/Feb-05-2009_6-46-am/ accessed October 18, 2009.
[17] Michael Lewis and David Einhorn, "The End of the Financial as We Know It," January 4, 2009, The New York Times, www.nytimes.com/2009/01/04/opinion/04lewiseinhornhtml (accessed October 18, 2009).
[18] During the eight year period for which data is available (1994-2001) turnover rates for SEC attorneys averaged 14.05% while turnover rates for government attorneys generally averaged only 7.6%. These figures calculated from data contained in United States Securities and Exchange Commission, "Pay Parity Implementation Plan and Report," at pp. 5-7 , May 6, 2002, http://www.sec.gov/news/studies/payparity.htm Accessed October 18, 2009.

are in crisis and to eschew the development of market mechanisms that might solve the very problems that the SEC is tasked with. This puts the SEC in a difficult position. On the one hand, of course, the SEC wants to be viewed as successful. On the other hand, if financial crises did not arise every so often the SEC might well come to be viewed as unnecessary, as many argued for a time.[19] From the SEC's perspective, the optimal way to handle this balancing act is to blame any and all failures on a lack of resources. The SEC pursued this strategy with great success after the collapse of Enron in 2002. The SEC long claimed that it faced a "staffing crisis" due to its "inability to compensate our employees adequately."[20]

Ironically, over the past decade, starting with the collapse of Enron in 2001 there have been unprecedented budget increases for the SEC staff. In some years the SEC was the only federal agency to receive substantial budget increases both in 2003 and 2004.[21] Finally, notwithstanding the fact that the SEC's budget that nearly tripled between 2000 and 2010, the Commission's current Chairman and senior staff have argued that its recent failures can be addressed by increasing the agency's funding.

**5. The SEC's is not Knowledgeable About Economics of Its Own Regulation**

*Price Fixing on U.S. Capital Markets Ignored by the SEC*

The first example of empirical work in social science that launched a major regulatory response was William Christie and Paul Schultz's article in the Journal ofFinance, "Why Do Nasdaq Market Makers Avoid Odd-Eighth Quotes?". Christie and Schultz examined trading in the Nasdaq stock market, which, along with the New York Stock Exchange (NYSE), is one of the two principal equity-trading markets in the United

[19] Macey, Obsolence, supra.
[20] United States Securities and Exchange Commission, "Pay Parity Implementation Plan and Report," May 6, 2002, http://www.sec.gov/news/studies/payparity.htm. Accessed October 18, 2009.
[21] Susan Dudley and Melinda Warren, "Regulatory Spending Soars: An Analysis of the U.S. Budget for Fiscal Years 2003 and 2004," 2004 Annual Report (July 2004), 14-19, http://wc.wustl.edu/Reg_Budget_final.pdf.

States. Like other U.S. equity markets, the NASDAQ stock market competes for listings and for order flow by offering an attractive trading venue to purchasers and sellers of equity securities. What Christie and Schultz found was not just price fixing, but probably the most subtle, ingenious, and successful price fixing scheme since Adam Smith began to worry about the problem in the eighteenth century. This discovery led to massive antitrust and securities enforcement efforts that entailed a private class action lawsuit with a settlement of over $1 billion, an investigation by the U.S. Department of Justice into price fixing that concluded with total fines on major U.S. investment banks exceeding another $1 million, as well as dramatic new regulations and market practices concerning not only the way orders are handled in the securities markets, but also how securities prices are quoted.

*Mutual Fund Late Trading*

Another example of empirical scholarship in social science that launched (literally) a thousand (or more) lawyers into action was work done in 2004 by Eric Zitzewitz, a young assistant professor who was then at the Stanford Graduate School of Business. Zitzewitz's work examined trading in U.S. mutual funds. Zitzewitz pointed out that the prices at which mutual funds bought and sold their own shares from their investors often were inaccurate. This, in turn, gave crafty institutional investors such as hedge funds the ability to transfer wealth to themselves from unsophisticated mutual fund investors. As Zitzewitz described the problem:

> Investors can take advantage of mutual funds that calculate their NAVs using stale closing prices by trading based on recent market movements.... For example, if the U.S. market has risen since the close of overseas equity markets,

> investors can expect that overseas equity markets will open higher the following morning. Investors can buy a fund with a stale-price NAV for less than its current value, and they can likewise sell a fund for more than its current value on a day that the U.S. market has fallen.

`The SEC clearly was aware of the problems caused by stale pricing. The Commission jawboned the mutual fund industry to eliminate the possibilities of abuse by using what is known as "fair value pricing." Fair value pricing involves providing more frequent price updates for securities that have not traded for a certain period of time. The fair value price is determined on the basis of the price that an arm's-length buyer would pay for the security at the relevant time. Interestingly, it appears that when the mutual fund industry resisted the SEC's efforts to reform the industry's pricing practices, "the SEC essentially backed down; Elliott Spitzer, then an ambitious, entrepreneurial state Attorney General, brought an investigation. Ultimately, virtually every major mutual fund complex was investigated and late trading ground to a virtual halt as a result of his efforts. These enforcement measures were probably inconsistent with applicable SEC regulations that clearly permit such activities.

*Options Backdating*

The third major regulatory initiative, which addressed the backdating in the granting of corporate stock options to corporate executives and other employees, was years in the making. In 1997, David Yermack, Professor of Finance at New York University, published a paper on the relationship between stock prices and option grants. Yermack was interested in the ability of corporate managers to influence their own compensation. Utilizing a sample of 620 stock option awards to Chief Executive Officers (CEOs) of the largest U.S. corporations made between 1992 and 1994, Yermack found that the timing of stock option awards coincided uncannily with favorable movements in company stock prices. Specifically, CEOs received stock option awards shortly before favorable corporate news that led to upturns in company share prices. Professor Yermack was not able to explain whether executives were receiving stock options at low price points because of luck, prescience, or some other factor.

Research in 2004 by Professor Erik Lie was the first to suggest a nefarious explanation for the timing of executive stock option grants. Professor Lie's research indicated that the best explanation for the timing of stock option grants might be rather unsavory. He posited that the available evidence was consistent with the theory that public companies were backdating stock-option grant dates to enrich their senior executives. \

Options backdating is the practice of granting an employee a stock option that permits the grantee to purchase shares at a lower price recorded on a date *prior to* the date that the company actually granted the option. For example, suppose that a company's share price was $25 per share on March 1,2008, but has risen to $35 per share on April 30. Clearly, an option to purchase stock in the company at the lower March 1 price is more valuable than an option to purchase stock in the same company at the higher April 30 price. Such backdating raises potential legal and regulatory reporting and disclosure problems. Professor Lie extended the earlier work of Professor Yermack by examining options grants by companies that granted options to executives in consecutive years, but not on the same day every year. Professor Lie discovered a pattern: stock prices systematically tended to fall just prior to the date on which the options were said to have been granted, but they rose almost immediately after the grant. In other words, if one thinks of a stock-price chart, options were granted at a dip in the market price that preceded a price increase.

Of equal interest to Professor Lie was the fact that the options granted to lucky executives did not always precede good news about the particular company for which an executive worked. Instead, options often appeared to have been granted just prior to increases in stock prices for the entire stock market that had nothing to do with any events in the company granting the options. In other words, the executives receiving stock options grants not only appear to have been very prescient about news at their own firms; they also appeared to have been very prescient about the stock market in general. These results led Professor Lie to the conclusion that "at least some of the awards are timed retroactively.

Dr. Lie actually sent a copy of his article to the SEC in early 2004 and later received an acknowledgement stating it was "interesting." Then, in March 2004, building on Lie's work, the *Wall Street Journal* printed a story on the front page that reported on Lie's study and used its own statistical analysis to identify several companies with highly suspicious grant practices. Amongother findings, the *Wall Street Journal* looked at several option grants made to Jeffrey Rich, the former chief executive officer of Affiliated Computer Services, Inc. Ostensibly, all of these grants were made immediately prior to sharp spikes in Affiliated's share prices. The *Journal* estimated that the odds against this happening by chance were 300 billion-to-one, twice as bad as the 146 billion-to-one odds against winning the Powerball lottery with a $1.

After that, the SEC, DOJ and state enforcement actions came fast and furious.

The Commission's regulatory and management failures are attributable to the incentive problems and cultural pathologies described here.

Mr. MCHENRY. Thank you for your testimony.
Commissioner Campos.

**STATEMENT OF ROEL C. CAMPOS, ESQ.**

Mr. CAMPOS. Thank you very much. Good afternoon. I wish to thank Chairman Issa, Ranking Member Cummings, and the other distinguished committee members for the invitation to testify today. My name is Roel Campos. I'm currently a partner with the national law firm of Locke Lord Bissell & Liddell, where I practice securities law. I represent businesses and individuals.

I come before you today not as an expert or an advocate on a particular regulatory change, in particular ones that the committee is considering. But instead I testify today from the perspective of a former SEC Commissioner. Like you and the SEC currently, during my tenure as an SEC Commissioner, I often faced the difficult challenge of how best to reform and improve securities laws and regulations.

I learned firsthand how difficult it can be to balance the goals mandated by Congress, protecting investors, but also facilitating capital formation and preserving the integrity of the markets.

With your permission, my testimony today has two modest goals: Presenting a very short discussion of factors in consideration that must be balanced to produce sound regulations and offering observations and suggestions to assist the SEC to achieve appropriate reform of current securities regulation.

First, let me briefly begin by discussing investor protection. In my experience, this concept, when raised, regularly produces cynicism and the disbelief that this is a serious goal in today's complex environment.

Many seem to believe that the concept of investor protection is archaic and long ago ceased to be useful, that it is a musty relic of a bygone era, the market crash of 1929.

I respectfully disagree. I submit that investor protection remains today as important as it was 80 years ago when Congress made it the fundamental underpinning of the securities laws.

As a commissioner, I was often asked with respect to investor protection, Well, what investors exactly and do investors really need much protection? Certainly the term "investor" is very broad. Congress and the SEC have never made a distinction among the categories of investors which include institutional investors, i.e., pension plans, which can represent public and private employees, and often include in professional investors, private asset managers, and hedge funds.

And finally there is the distinction of retail investors, the everyday person who holds a brokerage account or who tries to manage his or her retirement plan. During my tenure at the SEC, I was privileged to represent the Agency in the international arena where I learned firsthand that our markets are unique. Securities markets in Europe and Asia are comprised almost exclusively of institutional and professional investors. In the United States, however, retail investors provide a significant portion of the capital that is invested. Retail investors, therefore, add a depth of liquidity and offer a diversification to the investor base, to the U.S. markets that cannot be found elsewhere in the world. Indeed, the liquidity and the diversity of the U.S. markets help convince many foreign investors to invest in the United States.

As a commissioner, I worried most about retail investors, as the others often have strong associations and lobbyists to present their views and their needs to the Commission and to the SEC staff. So the retail investors, however, are the ones who most quickly can leave the markets when the problems rise. And as was discussed in the first panel, when there is a crash, when there is a problem, those particular investors flee the fastest.

Let me move to some ideas that I have regarding the situation that we have today.

The SEC has stated in the panel very clearly that they're willing to look at these particular issues, that they're willing to consider reform. In fact, they're—Chairman Schapiro and Meredith Cross were very clear about that. However, there has always been, and I submit continues today, a deep annoyance that the SEC takes too long to consider new ideas and recommendations for improvements. This problem arises from, I submit, resources, insufficient staff that have other skills that go beyond being lawyers. So I would submit that's an area of consideration for this particular committee.

And with that, I see my time is up and I thank you for permitting me to make these statements.

[The prepared statement of Mr. Campos follows:]

LLB&L

Locke Lord Bissell & Liddell LLP

Attorneys & Counselors

701 8th Street, N.W., Suite 700
Washington, DC 20001
Telephone: 202-220-6900
Fax: 202-220-6945
www.lockelord.com

Roel C. Campos
Direct Telephone: 202-220-6931
Direct Fax: 202-661-2631
rcampos@lockelord.com

FORMAL WRITTEN TESTIMONY OF ROEL C. CAMPOS, ESQ.

DELIVERED BEFORE THE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM, U.S. HOUSE OF REPRESENTATIVES

"THE FUTURE OF CAPITAL FORMATION"

TUESDAY, MAY 10, 2011

Good afternoon. I wish to thank Chairman Issa, Ranking Minority Member Cummings, and the other distinguished Committee Members for the invitation to testify today. My name is Roel Campos. I am currently a partner with the national law firm of Locke Lord Bissell & Liddell LLP where I practice securities law, representing businesses and individuals. I come before you not as an advocate or expert on the particular regulatory changes that the Committee has posed to the Securities and Exchange Commission ("SEC"). Instead, I testify today from the perspective of a former SEC Commissioner. Like you and the SEC currently, during my tenure as SEC Commissioner, I often faced the difficult challenge of how best to reform and improve securities laws and regulations. I learned first-hand how difficult it can be to balance the goals mandated by Congress: protecting investors, but also facilitating capital formation, and preserving the integrity of the markets.

With your permission, my testimony today has two modest goals:

(1) Presenting a short discussion of the factors and considerations that must be balanced to produce sound regulations; and
(2) Offering observations and suggestions to assist the SEC to achieve appropriate reform of current securities regulation.

As you know, I had the privilege and great honor of serving as a Commissioner of the SEC. Confirmed twice by the Senate, I was in office from 2002 to 2007. During my tenure, like today, the SEC faced the aftermath of a serious financial crisis from the scandals presented by the cases of ENRON, WorldCom, and others. Then, like today, Congress passed major legislation to deal with the abuses that occurred—the Sarbanes-Oxley Act of 2002. Today, like then, the SEC faces the aftermath of the severe financial crisis in 2008, and Congress has passed another major piece of legislation—the Dodd-Frank Act Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), directing the SEC to implement Dodd-Frank.

First, let me begin by briefly discussing "investor protection." In my experience, this concept, when raised, regularly produces cynicism and the disbelief that this is a serious goal in today's complex environment. Many seem to believe that the concept of investor protection is archaic and long ago ceased being useful—that it is a musty relic of a bygone era, the market crash of 1929. I respectfully disagree. I submit that investor protection remains today as important as it was 80 years ago, when Congress made it the fundamental underpinning of the securities laws. As a Commissioner, I was often asked with respect to investor protection, "What investors exactly? And, do investors really need that much protection?"

Certainly, the term "investor" is very broad. Congress and the SEC have never made a distinction among the different categories of investors, which include: institutional investors (*e.g.*, pension plans, which represent public and private employees), professional investors (*e.g.*, private asset managers and hedge funds), and finally retail investors—the everyday person who holds a brokerage account or tries to manage his/her retirement plan.

During my tenure at the SEC, I was privileged to represent the agency in the international arena, where I learned first hand that our markets are unique. Securities markets in Europe and Asia are comprised almost exclusively of institutional and professional investors. In the U.S., however, retail investors provide a significant portion of the capital that is invested. Retail investors thereby add a depth of liquidity and offer a diversification of investor base to U.S. markets that cannot be found elsewhere in the world. Indeed, the liquidity and diversity of the U.S. markets help convince many foreign investors to invest in the U.S.

When I was a Commissioner, I worried most about retail investors, as institutional and professional investors have strong associations and lobbyists to present their views and needs to Commissioners and SEC staff. As for the vast majority of the American public, few speak on behalf of the "retail investor" to Congress or the SEC. Protecting investors is certainly rooted in equity and justice. However, there are other fundamental reasons for protecting investors. America needs investors to participate in our markets without fear of being defrauded or being victim to tricks and stratagems. If U.S. markets are viewed as "unsafe," all categories of investors will abandon our markets.

This is not idle worry. After every scandal or malfunction of the capital markets, investor confidence is damaged and retail investors in particular leave the market and stop buying equities and other securities. The recent financial crisis in 2008 demonstrated this, and studies show that retail participation has not yet returned to pre-2008 levels. Consequently, if our markets experience a sustained loss of investor confidence, they will permanently lose liquidity and cease to be the source of capital to drive growth and jobs for our economy. Without deep and vibrant markets, America's economy will most likely stagnate and produce a lower standard of living for its people.

But there is yet another consideration: Americans today must mostly fend for themselves and self-manage their retirement savings. Most of us do so through 401(k) plans that require us to make investment decisions. Gone for most Americans are the days when their employer maintained an employee pension and guaranteed a particular defined benefit after they retired. Surely, Congress and the SEC owe the vast portion of our population safe and stable markets that are free of fraud or mischief and in which they may choose stocks and debt instruments to maintain themselves in their elder years. For all these reasons, investor protection should not be taken lightly, and its consideration is vital in any reform of securities regulation.

A second principle is that regulation that protects investors does not impede capital formation but instead attracts capital. I remember vividly, as a Commissioner, when one European institutional investor told me: "I invest hundreds of millions of dollars in equities in America because I consider American markets to be the safest in the world." During my tenure, I debated and contrasted U.S. markets to other jurisdictions, such as the U.K. and others, that maintained what was regarded as a "light touch regulatory regime." I defended U.S. markets and argued that America placed, as its first priority, the protection of capital and that this principle would continue to be a magnet for capital from around the world. I argued that the primary concern of any regulator had to be the safety of capital and that the financial services professionals would follow the capital. It is clear today that the U.K. and other jurisdictions have revised their views and imposed on their markets a system of regulation that also places investor protection at the top of their priorities. Again, capital finds the markets where it is best protected.

There is a danger in accepting, without careful analysis, the view that U.S. markets are in some type of major decline. I agree that there are currently significant challenges to our markets. However, statistics showing that foreign IPOs in the U.S. have declined must be interpreted in the context of the global economy and on a longer timeline. There was a time when the U.S. markets were the only source of capital for large offerings. During the recent past, the number of large pools of capital, including sovereign wealth funds, in Europe, the Arab world, and Asia grew tremendously. Companies do not have to come to the U.S. to raise capital. Moreover, studies show that the natural shareholder base and constituency for any public company will be those living within the geographical region in which the company has its principal places of business.

I therefore believe that some comfort can be drawn from those statistics, which show that foreign companies continue to view U.S. markets as an attractive source of capital, and many issuers still choose to list on U.S. exchanges even though they do not need to raise capital. In fact, registering in the U.S. provides foreign companies the opportunity to use their shares as currency to acquire American companies for strategic growth. More acquisition opportunities exist in U.S. markets than in most foreign markets. In addition, one cannot ignore the large amount of capital that is raised in the U.S. through private placements in which many foreign companies participate. And, finally, U.S. exchanges have become international in their operation or have foreign exchanges as partners, and U.S. investment banks participate vigorously in Europe, the Arab world, and Asia and benefit from the capital raising activity in those regions. All of this, however, lessened the need for foreign issuers to pursue IPOs in our country.

A third principle to keep in mind is that the SEC has always been open to improving its rules and regulations. The business on Main Street, the capital markets, and technology constantly change; oversight continues to adapt to such changes. During my tenure as a Commissioner, I wrote an article supporting Securities Act reform to enable more efficient offerings and improve the ease of raising capital. I was elated when the SEC's Corporate Finance Division formally recommended Securities Act reform, and many of the ideas that I had supported were ultimately adopted. Also note that there are many other examples of the SEC taking initiative and tackling areas of regulation that needed reform. One of them was the SEC's efforts to modernize the markets through the adoption of the National Market System, which offered new transparency and efficient access to the best price, regardless of the market. As testified by Chairman Schapiro, the SEC is ready and has a history of being open to ways of improving rules and regulations.

Obviously, there has always existed, and continues today, deep annoyance that the SEC takes too long to consider new ideas and recommendations for improvement. Frankly, the reason it takes so long is that there is almost never widespread agreement on any proposal. Business interests often have competing stakes in the respective business models and disagree among themselves. Add to the mix that investor groups do not easily abandon rules that have offered transparency and protection, and consequently, they therefore often pose substantial objections to changes. Finally, the decisions that must be made are truly complex and any solution will of necessity be viewed as negative by some participants.

Moreover, consider that the SEC is an agency consisting principally of lawyers. However, the skills and training that are needed to evaluate capital formation or the efficiencies and working of the markets are often not those of lawyers. Clearly, the SEC needs more economists, statisticians, financial researchers, and those with experience in the day-to-day workings of the markets and computer systems that are currently used in the markets. In my role as international Commissioner, I was struck at how other countries viewed the regulation of their securities markets as a top priority. To that end, governments regulating financial centers such as London or Hong Kong offer their senior staff compensation that is comparable to the levels of the private sector. That is in stark contrast to the approach in our country, where there is little consideration for the need to attract the regulatory and financial talent necessary to respond appropriately and confidently to the complex demands from many constituents. It seems to me that investment in resources at the SEC could allow the agency to respond more efficiently and confidently to the demand for approval of new financial products as well as to study and recommend regulatory improvements.

I realize that Congress is in no mood to increase funding for any part of government, much less for the SEC. However, the irony is that the improvements and efficiencies of the type that this Committee demands can only occur on an expedited basis if additional resources are brought to bear. Appropriately skilled staff could perform more rapidly the necessary studies with correct statistical significance, evaluate the costs and benefits imposed by its regulations, study commentary by the market participants, conduct follow-up surveys, and properly weigh investor protection with the resulting efficiencies in capital formation.

A concept that I have viewed favorably is the establishment of a permanent citizens' advisory board for the SEC that would include members of the regulated industry, public companies, and investor representatives. The Fed has such a board. This advisory group should have resources and be supported by SEC staff. One could jump-start and incorporate into this board the SEC's long-standing use of outside groups of distinguished individuals who present well studied suggestions for improvement of regulation. Relying on an advisory board, however, will not speed up consideration of new ideas for reform. Its limited resources and its members' limited and voluntary time will by necessity not suffice to efficiently and promptly draft sound regulations.

Another approach that may seem heretical, but that deserves consideration, is permitting the SEC to raise the fees it charges registrants and other users of its services. Such additional revenue, subject to scrutiny and budget requirements, could be used to expand the SEC's capacity to efficiently consider new reforms. Congress could certainly specify the particular subject areas and studies that could be funded from such additional revenues to assure the focus it desires.

Ultimately, I agree that there are many areas of securities regulation that demand substantive attention for improvement and reform. In addition to the areas raised by this Committee, many have pointed out that the workings of the markets need new study. To many, the recent flash crash has not been satisfactorily explained. The full impact of the use of computerized trading has not been fully studied. Further, many worry that despite improvements in regulations, such as Reg SHO and 204T, the markets still seem vulnerable to manipulation from failure to deliver shares after short sale orders of exchange trade funds (ETFs). Others worry about the serious fragmentation of the markets and the existence of untransparent dark pools. There are certainly many other areas of concern.

Again, without additional resources, it is difficult to see how the SEC can accomplish all of the mandates of Dodd-Frank and study new ways of facilitating capital formation, as well as oversee markets that are dominated by giant computers doing analysis and trading in nano-seconds.

Business and the financial services community need a smart twenty-first century regulator. Other jurisdictions view investment and market-competitive compensation for their regulators as an important contribution to help their markets attract capital. In the United States, we should have the same view.

Thank you very much for your kind attention. I am happy to answer any questions you might have.

Mr. McHENRY. I certainly appreciate the panel's testimony. It's very informative and helpful for policymakers here in Congress to hear from you.

We'll lead off with 5 minutes from Mr. Meehan of Pennsylvania.

Mr. MEEHAN. Thank you, Mr. Chairman, and thank you for this distinguished panel, again, in addition to those who came before us. I am struck by the remarkable amount of willingness on this panel to be taking creative looks at where we ought to be going with the SEC.

Mr. Silbert, I had the opportunity to spend a little time paying some attention to your business model. Very impressive in terms of what struck me is the idea that you really have created a market for sophisticated investors, people who take the time to understand that there's a lot of different kinds of securities out there that can become able to be liquid, which both creates liquidity; it also allows people to participate that may not reach this threshold for sophisticated investors.

Can we expand the definition of "sophisticated investor" some way to include the kinds of people that put the sweat equity in understanding things but may not have the dollars behind their name to take the risk?

Mr. SILBERT. Congressman, it's an interesting idea that I think has been floated over the past 6 months, 12 months, as this private company market has grown in value or volume.

The way we operate right now, as you're alluding to, we only allow accredited investors to participate. And while we would certainly kind of welcome the expansion of the addressable universal investors, we have to comply with the current regulations. The idea of a test I think is a viable one, but I think it then comes down to who administers the test and things like that.

Mr. MEEHAN. Dr. Rahn, you had talked about this 2 percent factor. What criteria that would be able to be utilized in this to create a class that would be able to invest without having the——

Mr. RAHN. Well, the main thing we want to know is, have people actually paid attention? All of us make all kinds of investments. We buy houses and automobiles. One can go to Las Vegas and gamble away your fortune. You don't have any net worth requirements on that. We have people who are totally unsophisticated. If we came up with a notion of accredited gambler, people would look at that as laughable. We have the State lotteries, which I look as a total financial rip-off.

But I think the main thing, rather than trying to say you have to have a certain net worth or a certain education. If the SEC gave a piece of paper to everybody who was going to invest, or if we had one and it first pointed out the low probability of new ventures, you know, give whatever statistics we had on that, warned people against it, like we do lots of other types of warnings for everything from cigarette labels and everything else, and say you have to do your own due diligence. Just the mere existence of the SEC adds risk.

Look at all of the investors in the Madoff Pyramid scheme who claimed one reason they felt confident is because the SEC exists, rather than doing their own due diligence. And obviously we really have to have a way to protect people who really can't do any kind of evaluation on their own.

But the vast majority of Americans I think have the brains and the skills to be able to do this and to rule out all but 2 percent of our citizens, because what that does is discriminate against young people and others who want to get rich. We're saying now, only the people who are already rich can have the access to the best opportunities. That seems to me totally un-American.

Mr. MEEHAN. Professor Macey, you were precluded from getting in the full scope of your testimony by the 5 minutes, but I enjoyed reading your testimony. And I was a little bit—at some points, I was struck by your notion that tied into one of the questions I asked about China. The markets have changed dramatically in the years since World War II. And you made a comment. You said the SEC needs to make a clean break with the past relating to the fact that the capital markets aren't the only ones in the United States now. We're turning into a global marketplace. There's more than one cop on the beat. Where do we go?

Mr. MACEY. As I think I try to say in my testimony, I think the people of the SEC are extremely bright and talented and well meaning, honest, full of integrity. But there are—I think that we, and when I say "we" I mean those of us in academia, the people, frankly, who oversee, the people in Congress who oversee what the people at the SEC do kind of inadvertently give these folks very perverse incentives.

So for example, we heard in the first panel this morning something that we always hear from the SEC when they're being questioned. They say, We're doing a really good job. Look at the dollar amount in fines we fined Goldman Sachs, this huge amount of money. We've increased every year the amount of fines, that we returned $2 billion to the U.S. Treasury.

So we've set this up as the criteria by which we judge the SEC. That means that what they're going to do is go after the biggest fine they can. That does not help the small or medium-sized investor. The smaller, medium-sized investor by definition loses small and medium amounts of money.

So we're giving the SEC preferences.

Another example is not just the SEC but our society generally is much more kind of, if you will pardon the expression, "lawyered up" than other societies. And a lot of what the SEC does—because it is much more dominated by lawyers than any other regulatory agency, either in the United States or in terms of its counterparts in other countries. If you're working at the SEC, you really cannot make a career for yourself by making the securities regulations simpler. No one wants to hire you to work at a big Wall Street firm to charge you a lot of money to interpret simple regulations.

The more complex you make it and the fewer people who understand it, the higher value there is on your time in your post-SEC world.

So I think we have these challenges that we need to—it is not just a matter of—I don't think it's at all a matter of the people at the SEC having a bad—you know, just being in favor of more regulation for kind of senseless reasons. I think there's these very deeply kind of impacted structural issues that no one had to pay any attention to in the postwar period, because there weren't any other capital markets in the world.

During the Marshall Plan, as you well know, Europe was being rebuilt; Asia, China had not emerged as a serious economy; Japan was being completely rebuilt from the ground up. So nobody who wanted to raise capital in any serious way could avoid the United States. I think it's very important to understand that times have changed.

Mr. MCHENRY. The gentleman's time has expired.

Mr. Cummings is recognized for 5 minutes.

Mr. CUMMINGS. Mr. Campos, you heard Dr. Rahn talk about only 2 percent, and he felt like it should be more like 50 percent of the people investing; is that right, Dr. Rahn?

Mr. RAHN. Yes, sir.

Mr. CUMMINGS. What's your feeling on that? I mean, you seem to be very concerned about the retail investor. I think what Dr. Rahn is saying is there are a lot of people who are much more sophisticated than maybe we think. But what's your feeling on that? In other words, how much protection do you think is needed? And he claims that we're basically locking people out. You talked about the college kids and young people and whatever.

I am just wondering, I know you're talking about striking a balance, but do you think we're going too far?

Mr. CAMPOS. I think that is the fundamental question in regulation. And that's where and why you have such heated discussions at times, because you're dealing with a broad concept, investor protection, within the aftermath of the 1929 crash when all of these laws were written. And we have a very different world and a very different economy today.

So when we talk about investor protection, I think you can achieve investor protection by finding a way to allow all categories of people—not necessarily through a financial test—to be able to participate in particular investments.

The real protection that's necessary is the idea that investors of whatever category can get taken advantage of and can be lied to and can be cheated and be misrepresented, or critical facts can be hidden. So you can achieve this, I believe.

It may be ironic to some people but I favored, when I was at the SEC, products that allowed under the Investment Company Act, mutual funds—that allowed small investors to have a taste of some of the more complex items if they were placed correctly in funds and regulated. I felt why should only rich people have essentially the opportunity to have the more sophisticated ideas and complexes?

So in summary, in a stimulus summarize, investor protection goes toward the idea that you need a system that people are not expecting to be guaranteed making money or profits. That's not what we have here. You can pick a stock and it may not go up, it may go down, but the key is in so doing you're not going to be cheated. This particular company didn't have the cash that it said it had on hand or something else to lure that particular investor.

So that's what's important. And I think I would have other things to say about the SEC if ever anybody is interested in that.

Mr. CUMMINGS. One of the things you say in your testimony, you state that after every scandal or malfunction of capital markets, investor confidence is down and retail investors leave the market. What can the SEC do to help boost investor confidence in the U.S. capital market?

Mr. CAMPOS. Great question, and people will disagree on that one as well. But essentially what we need today, in my humble view, is we need a market that operates in a way that doesn't mystify, worry, perplex investors. I submit and I think all of us would say it's true if the market plunges 80 percent, you know, stocks go from $40 to $2 in the space of 5 or 10 minutes, something is wrong. And that is a scary event, if you permit me that term.

So from the get-go, I think that the markets need, you know, careful study in that particular area.

What does fast trading—what does fast trading, in nanoseconds, what has that done to the average person whose broker is somebody he knew of in high school and has his few hundred thousand dollars, if it's that much in today's world, for his savings? Can he or she just invest in IBM now, or whatever the popular stock, Apple or whatever? Something is going on in these markets. That needs study. That needs help, in my view.

Mr. CUMMINGS. Somebody asked a question. They said that the system is so much—things are so much different than back long ago. Do you think the SEC has kept up with that, the changes you talk about, the nanoseconds?

Mr. CAMPOS. I agree with what many others are saying. I think the SEC was established in terms of concept in the 1930's. It's an Agency of lawyers. We need today statisticians, researchers, economists. The sort of things that the chairman and you would like to do in terms of getting the SEC to look at things quickly and efficiently requires those types of skill sets. It requires resources that the Agency doesn't have.

What they have to do is go out, survey the system, survey the literature, ask for comments, and then it's essentially a who pushes the hardest in terms of the players, a very difficult situation. Imagine a judge in a courthouse having to take opinions from 40 different sections and reading all the research themselves. It is a very difficult situation in terms of figuring out what's best for the markets, in particular when you don't have the base of expertise.

So I do believe that one great improvement would be that the Agency get resources to have those types of people involved.

Mr. CUMMINGS. Thank you very much.

Chairman ISSA. I thank the gentleman.

The gentleman from North Carolina.

Mr. MCHENRY. Thank you, Mr. Chairman.

Mr. Koester, how important is access to capital to you in this startup.

Mr. KOESTER. Thank you very much. It's actually an excellent question, and I'll address it personally from my current business as well as from advising startups over time.

I think it's the difference between a nice side of business that supports your family and a business that really contributes in a dramatic way to the U.S. economy. The business that we've started, Zaarly, is a business that we hope will have a dramatic impact on markets, person-to-person commerce, and hopefully have an impact on employment. But that's only accessible to us because of the fact that we had forward-thinking investors to put capital in early and efficiently. That allowed us to run very quickly to the point where we took a business from an idea to 12 weeks later to launching a very large-scale business.

Mr. MCHENRY. Now, in terms of getting employees to come in for a startup, is it important for them to have some method of sort of long-term payoff?

Mr. KOESTER. Absolutely. Absolutely. I think equity is an important thing for people willing to take that kind of risk. But I think that's the thing that is attractive about startup companies and early stage business is that risk/reward opportunity.

Mr. MCHENRY. Mr. Silbert, what function do you provide? Let's say Mr. Koester is able to hire a hundred whizzes at a very low cost, but with equity in the company, in the hopes that this one day goes public.

Mr. SILBERT. The issue today is, as I mentioned before, is it's taking twice as long to go public. So if you're looking at a process that's going to take 8, 9, 10 years, that doesn't work for anybody involved in the capital formation process. It doesn't work for employees. It doesn't work for individual investors. It doesn't work for investor capitalists.

So we identified a need to create essentially a spring training to enable companies to get to the point where they could go public but also not have to subject themselves to a lot of the negatives of being a public company, whether it's the Sarbanes-Oxley, or disclosure, that type of thing.

So what we have seen over the past couple of years, there are a growing number of companies that have come to appreciate that if you can allow your employees at a certain point in time, the right time, maybe it's 4 years, 5 years into it, allow them to taste some of value that they have created, that money is typically reinvested into other companies as well, and they're going to stay in it for the long haul and maybe wait for that 10-year IPO event.

Mr. MCHENRY. Mr. Koester, would that be appealing?

Mr. KOESTER. Absolutely. I think that it's appealing for employees to have that liquidity early.

I also think there's also a side benefit that's not often discussed, besides employees. It's that investors in my business are venture capitalists who have an obligation to get a return. And obviously if they can't get that return over time, they're slow to reinvest that money again into businesses.

So the fact that they can gain liquidity earlier in the process, from 10 years down to 5 years potentially, allows them to have two cracks at the apple and potentially invest multiple times, reap the rewards, and double-down essentially on early stage investments.

Mr. MCHENRY. Mr. Silbert, this 500 shareholder rule, as the chair of the SEC called it, arbitrary number, can you discuss that?

Mr. SILBERT. Well, it was established I guess in the sixties, and it worked for decades. But if you look at that chart, you know we're now at a point where it is not working any more. And what the numbers should become, should there be a number, I don't know. But what we do know is it's a major issue.

As I mentioned in my remarks, we certainly support eliminating the employees from the account, we certainly support eliminating credit investors from the accounts, but we would also like to see that analysis that's going to be prepared.

Mr. MCHENRY. This limits access to capital for these small businesses and it limits—Mr. Koester, it eliminates your ability to access capital and grow your company and grow your head count too, right?

Mr. KOESTER. Yes. I think it has a slow down. I think on the charts not shown up there is the decrease in venture capital investment, and I think that's also attributable to the lack of liquidity in the IPO markets. That I think has a downstream effect that limits the early stage investment rather than just the late-stage IPO investment. It is a double-edged sword, decreasing employment levels as well.

Mr. MCHENRY. It's important—this chart is interesting to look at in the terms of the number of IPOs.

I think many Americans misunderstand what the IPO is about. It's in order to get capital injected into your company, right, and to free up maybe some of the capital you've got invested in. But long term, it's really about accessing capital for that company so they can grow jobs and actually grow larger. That's the reason why you have shareholders who want to participate.

Mr. Macey, we discussed the 500 shareholder caps, your views on it, and sort of where you'd like to see this thing go.

Mr. MACEY. Well, certainly I just want to make two points about it.

First, I am against the 500 share cap. I think that particularly with respect to employees, it provides a real curb on the ability of companies to provide incentives different than cash compensation.

The point I want to make, though, that hasn't been made yet is simply to observe that there is a very close correlation between the 500 shareholder rule and a whole bunch of other rules. So, for example, we heard this morning something the SEC is very proud of—and I am not opposed to it—is there's a reform of a couple of years ago to say that employee stock options are exempt from this 500 count, so you can give all the options you want without coming under the 500 count norm.

But what I don't think the SEC fully grasps as it relates to the 500 shareholder rule is, it doesn't do me very much good to have an option to buy a share stock if that share stock is not publicly traded, or if there are big impediments to that company making an IPO.

Similarly, with respect to the 500 shareholder rule, let's say we exempt employees, we raise the number to some sensible level, we need to go beyond that to really help the U.S. economy create jobs, because we need to—we need to make that stock grant, just like the Oxley grant, worth something to the employees. And it becomes worth something the more liquidity it has, the more access the company has to the public offering market.

So I think the 500 shareholder rule is a terrific step in the right direction, but it's almost a cruel joke if you say to an employee, Here are your options or here are your shares, but it's too risky for us to go to public, so these shares are going to be restricted forever. That's not a great deal in my view.

Chairman ISSA. I now recognize the gentleman from Tennessee, Mr. Cooper.

Mr. COOPER. I am very open to the idea of changing the general solicitation rules and also the 500-person limit. I do think, though, that this hearing, as good as it has been, has only really highlighted two pieces of the puzzle, and it is a very large puzzle.

Having been an investment banker, I think that the structure in the investment banking industry is also very important to this. There have been a few glancing blows dealt to that topic, but the fact that analysts find it difficult to make a living following stocks, especially smaller stocks, is a fundamental problem. That also implies that the retail investor needs the help of an analyst, and ideally the help of an honest analyst that won't just lose the stocks that company happens to be underwriting at the time.

There are many issues in the structure of the investment banking field. One of them is the fact that proprietary trading has become so lucrative that it makes pretty much all fee-based services pale in comparison. And then that sets up a conflict of interest issue if they're in fact betting against the issue of their own client.

So that's a whole segment of the problem.

Another problem is many retail investors have the idea that all IPOs are automatically good. Well, many of them are disastrous. Many of them are a search for the dumbest dollars they can find in America. Overly valuing a company and leaving the poor retail investor holding the bag, perhaps has been seduced by an overly optimistic analyst report.

So the search for the informed investor is truly a difficult task. We saw this in one of the least heralded features of our recent session, money market funds. Most everybody has a brokerage account, and who knew? Who knew, whether the investors were accredited or not, the risk of breaking a buck on those funds? And I think the government had to step in with—perhaps the chairman can remind me—wasn't it a $3 trillion seat-of-your-pants guarantee? Which may have one of the most fundamental features of the bailout. Basically everybody in America was bailed out and no one wants to talk about that.

There are other features to that puzzle, but that should strike the heart of every investor out there. Even, I imagine, some university endowment funds didn't really know.

So it seems to me that one of the core issues here, since really money, according to most investment bankers, really isn't the issue. It is a question of company valuation. And who wants to acknowledge that? And the phrase in the business is, "You don't bet on the horse, you bet on the jockey." And the real shortage is not money, it's management talent and experience. But these are some of the unacknowledged puzzle pieces that are out there.

So I commend the chairman for holding this hearing. I know that he's founded a very successful company in his own right. But getting this right for the whole country is really going to be a challenge, because financial literacy probably has not increased over the years. And I am not sure that television advertising helps us a whole lot in understanding this.

So I shudder at the thought of some of these general solicitations that could be amazingly appealing but really just be hiding an investment that's not necessarily going to grow to the sky.

So I commend the expertise of the panel. This is indeed a deep issue, and you should be comforted in the fact that this committee has no legislative jurisdiction. It's really just a debating society.

Chairman ISSA. Would the gentleman yield?

Mr. COOPER. I'd be delighted.

Chairman ISSA. We do have a little bit. We do regulate the post office and we've got the District of Columbia.

I want to thank the gentleman. As you know, we didn't come into this hearing with pre-determination. Certainly Chairwoman Shapiro was very quick to say she knows some of these reforms have to happen, and it is mostly her mandate, and I think it's one of the reasons we want to have the encouragement of the SEC and support, while recognizing that most of it is for her to do and not in fact for us to do.

With that, we recognize the gentleman from South Carolina, Mr. Gowdy for 5 minutes.

Mr. GOWDY. Thank you, Mr. Chairman.

This would be for the whole panel. If you care to comment on the efficacy or constitutionality of the general solicitation ban, I'd like to hear your perspectives.

Not all at once.

Mr. RAHN. Well, it's easy for me to do, because I am not a lawyer. But I can read the English——

Mr. GOWDY. Sounds like you're bragging.

Mr. RAHN. Yes, yes. I can read the English language, however. And the First Amendment to me is very clear, and it seems to me there is a definite conflict there; and given the conflict, I prefer to go with the Constitution.

Mr. GOWDY. Mr. Macey, you look like you were gearing up to respond?

Mr. MACEY. I was winding up there a little bit. So there are two kinds of stylized facts around this issue on either side. One is, I think Congressman Issa made this point, that it's absolutely nonsensical that a pharmaceutical company has the right to advertise on television a prescription medication, and a company can't make a similar solicitation for securities. When you get off the airplane in Europe, you see that all the time.

The problem that lawyers have, I think on the other hand, with the issue that you raise about the general solicitation, is that if we start putting SEC rules, Congressman, under scrutiny from a First Amendment constitutional lens, we open up a real Pandora's box. Think about the Securities Act of 1933 and registration statement. That's a prior restraint on the press to say to a company, You can't send this document out to investors without going to jail until the Division of Corporation of Finance of the SEC says it's OK. That's also a First Amendment violation—in fact, something that's very commonly said around law schools—I don't think people have really—it's quite amusing—is that one thing one learns in law school is an unwritten rule of the United States is that the First Amendment doesn't apply to the SEC.

I was kind of astonished, actually. The best part of this hearing by far was when the Chair of the SEC said, Well, you know, maybe this is unconstitutional, but I have to uphold the law, and so I am going to ignore the Constitution where it conflicts with the law. That's not the way I learned kind of a hierarchy of documents in our system. That's the world we live in.

Mr. GOWDY. There certainly is precedent for executive branch entities not following laws that they believe are unconstitutional, even recent examples of it.

Mr. MACEY. I think that you have a moral obligation, if not a legal obligation, if you're the head of a U.S. administrative agency, to resign rather than enforce a law that you actually believe is unconstitutional.

Mr. GOWDY. Let me move to one other area and if I have any time left, I will yield to the chairman, who is an expert in this area and I clearly am not.

I think it may have been you, Dr. Macey, or you, Dr. Rahn, that commented on the perverse incentive to go after big fines because that's the way we judge success. And I tend to judge enforcement more by active prison sentences than I do the size of the fine. So accepting that the SEC is not the U.S. Attorneys Office, are you satisfied with the level of criminal prosecutions or fraud; and if not, what can be done about it?

Mr. MACEY. I think that if one looks at for example financial fraud, particularly insider trading prosecutions, I think that the problem that the government tends to have is, just as a general rule, is that they overcharge. That is to say, I think there are current prosecutions that I could cite as examples, but there are many, many examples that if somebody has done three things that involve really criminal fraud, I've never understood why the government would charge them with a hundred count indictment, where when you get to the number 97, 98, 99, 100, these are pretty big stretches as to whether the fraud applies to that conduct. Whereas I do think where people are actually ripping people off, let's go after them.

So that's one big problem that I have, that for what I think are structural bureaucratic reasons, there are incentives that the SEC has to say that everything is illegal unless we say it's legal. I think it would be more helpful if they said, Where you've actually really committed fraud here in these situations where we know we have, because the structure of a criminal trial is once the criminal defense attorneys cast doubt on a few of these items, then the government can't come in and say, Oh well, we weren't really serious about charging those. Here's what we really want the guy to go to jail for.

So I think we need to be more selective and go after real fraud.

Another thing is who are we really protecting? Somebody mentioned in the first panel, Gee, isn't this great that we fined Goldman Sachs so much money with respect to this CDO scandal and the way it was selling structured products to investors? I always like to remind my students that the people who were ripped off in that case were two financial institutions. One of them was IKB Deutch Industria Bank, a Dusseldorf, Germany, headquarterd bank. And the other was ABNM Amro, a giant financial institution in the Netherlands. This prosecution is not helping the U.S. small investors, not even helping U.S. investors; Certainly not helping small investors.

Mr. GOWDY. I would disagree with you, but when you rob another poor person we call it common-law robbery, and when you rob a rich company, we call it something else. And if for no other reason other than to just prop up what's left of public trust in our criminal justice system, I would just like to see more suits prosecuted and fewer folks who don't have the means to defend themselves.

Mr. MACEY. I agree. My point is simply I'd like to see more suits brought where the person who is being ripped off is not ABNM Amro. There are plenty of small investors who are being ripped off as well, and I'd rather have my tax dollars going to protect those guys. But I agree with you in general, more is better.

Mr. GOWDY. Thank you, Mr. Chairman.

Chairman ISSA. I thank the gentleman.

For a change, I am going to go last, not first. So I yield myself 5 minutes.

Mr. Silbert, the companies that are on your exchange, what's the number, how many of them are audited?

Mr. SILBERT. A hundred percent of the companies are audited.

Chairman ISSA. So they have the same audit standards as public companies, right? Let me rephrase that. They have audits as required for public companies.

Mr. SILBERT. Correct. The auditors tend to be the Big Four accounting firms.

Chairman ISSA. I realize if you want Goldman to take your public offering, the first thing you have to do is go to what used to be kind of the Big 10, the Big 8, the Big 6, and now the Big 4, which is becoming interesting since one of them has to give you a credit or, sorry, a debt evaluation. Another one can do something else. Pretty soon you run out of them able to do anything for you.

So whether you use Pricewaterhouse Coopers or a regional audit firm, the audit standard for Gap is essentially the same, isn't it?

Mr. SILBERT. Correct.

Chairman ISSA. So the standard for an accounting firm standing behind a qualified opinion is going to be the same for these companies, whether they're public or private; isn't that right?

Mr. SILBERT. Correct.

Chairman ISSA. Let me go through that sort of analogy.

We talked about the First Amendment. Dr. Rahn, you were pretty straightforward. You are a nonlawyer like myself. You read this very short chapter, written long ago. You know, it shall not be abridged, boom, move on. But let me ask you a series of questions just so we understand the nuances.

I've got an audited—a public accounting firm has done my audit. Right now if I print it in the newspaper or I give it to one of my investors and they post it on the Internet, I've committed no violation, right?

Mr. RAHN. As far as I know.

Chairman ISSA. But if I send it out to a group of potential investors, I've committed a violation, right?

Mr. RAHN. Appears to be.

Chairman ISSA. So if I send it out to just those people who I know could legally invest, I've committed a violation, while in fact if I give it to the New York Times or somebody posts it on the Internet—it's fine on my Facebook, right? I just can't drive people to my Facebook.

Mr. RAHN. You point out the absurdity of what we're doing.

Chairman ISSA. So when we talk about the First Amendment, and it sounds very lofty and when you go to the Constitution, you sometimes lose the C–SPAN audience because they say, Oh, well, that's not a recent document. The recent document of posting something on Facebook being OK, while not being able to go to investors of record who do this kind of investing repeatedly and sending them information soliciting them currently is not available.

Let us go one step further, though.

If JP Morgan and Goldman are being paid by my firm to go out and find people that's OK, right? They can go solicit the people who have accounts with them and they already know they can be qualified, right.

Mr. RAHN. Yes.

Chairman ISSA. All the major firms have—and I am getting "yeses." Let the record indicate those are all yeses. She's very good but she doesn't hear pantomime.

Let's understand that right now the current status quo allows large brokerage firms to make these markets. And, Mr. Silbert, you're larger than you once were, but you're not a conventional brokerage firm. You don't have a whole bunch of—and correct me if I'm wrong—you don't have a whole bunch of people paid commissions to go make these transactions, right?

Mr. SILBERT. So we do not have a distribution network like in Goldman Sachs; that is correct.

Chairman ISSA. But right now for Goldman and JP Morgan and many other—we always use Goldman because of their size, but we could use Bank of America, Merrill Lynch, too—they can in fact make these markets, have hundreds of investors behind a single name, and it's OK; it's just not OK for me to post to my Facebook and drive people to go look at it and consider investing, even if they're qualified. Is that the status quo we're dealing with?

Mr. KOESTER. And as a former startup lawyer, it is one of those rules that's oftentimes mystical to the individual who's doing it. But there's a lot of different ways that people wind up kind of finding magical ways to solicit without soliciting.

Chairman ISSA. Now, the chairman when she was here was unable to answer hypothetical questions for good reasons. She's doing a due diligence and I commend her for starting this process. But you all are here to answer the hypothetical. So I hope you knew that was the reason.

Hypothetically, if the SEC lifts the cap on the 500/499 on all those who are in fact employees receiving options and those options maturing, because that ultimately makes them stockholders, that's OK with all of you; is that right?

[All witnesses answer "yes" together.]

Chairman ISSA. And if they take—and hypothetically the SEC takes a standard that they oversee; in other words, an SEC list of qualified investors, and they lift the cap on that list of investors, those who either with the help of a JP Morgan or Goldman or somebody, or on their own fill out a form and show that they in fact should be not part of a limit protection in this kind of investment, and she takes the cap off, is that OK with all of you?

[All witnesses answer "yes" together.]

Chairman ISSA. So as we close, and the ranking member may want another round, but as I close, we have two major items here—the employee who has a benefit limited unless we take the cap off for them, and the qualified investor who either is limited because there is only 499 option, or is unlimited because they are a conduit through. If we allow for that direct and the solicitation of those registered investors, that's good with everyone on this panel; is that right?

[All witnesses answer "yes" together.]

Chairman ISSA. I'll take that as a "yes" from everyone. I hope that as the chairman considers all of this, that you're all listened to.

Would the ranking member like another round?

Mr. CUMMINGS. No.

Chairman ISSA. With that, as we said earlier, for 7 days the record will remain open, that includes all of you, to revise and extend. I thank all of you for your testimony.

We stand adjourned.

[Whereupon, at 3:20 p.m., the committee was adjourned.]

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