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Before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs
of the
Committee on Oversight and Government Reform of the
United States House of Representatives

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Chairman McHenry, Ranking Member Quigley, and members of the Subcommittee: thank you for the invitation to appear before you today.

Introduction

The JOBS Act is an important achievement.

It was enacted with overwhelming bipartisan support, even though we're in an election year. If you hear complaints that no one seems to be able to get things done in Washington, you can point to the JOBS Act as an exception. It passed in the Senate with well over 70% of the votes cast in favor. Here in the House, it passed with well over 90% of the votes cast in favor. And if my research is correct, every single member of this Subcommittee voted in favor of the JOBS Act. That's a remarkable level of support.

If you had to pick out the single day on which the process that ultimately led to the JOBS Act got started, you'd probably say it was Tuesday, March 22, 2011.

On that day, Chairman Issa sent a letter to SEC Chairman Schapiro.[1] In that letter, Chairman Issa pointed out that over the preceding decade or so the number of IPOs in the United States had plummeted, while the number of companies listed on US exchanges had also dramatically declined. Chairman Issa's letter then asked a series of questions seeking to determine what could be done to address the crisis in capital formation.

On the very same day, Treasury Secretary Geithner convened the Access to Capital Conference to address the Administration's own concerns about these unfavorable developments.[2] That conference resulted in the formation of a private sector group dubbed the "IPO Task Force." The IPO Task Force subsequently released its report "Rebuilding the IPO On-Ramp"[3] in October 2011, and many of the recommendations in that report ultimately were enacted as Title I of the JOBS Act.

Meanwhile, throughout 2011 a variety of bills were introduced, mostly in the House, but also in the Senate, to address the problems identified in Chairman Issa's letter to Chairman Schapiro. Notable among those bills was H.R. 2930, "The Entrepreneur Access to Capital Act,"[4] which was introduced by Chairman McHenry in September 2011 to legalize the crowdfunding of small enterprises. On November 3, 2011, Chairman McHenry's bill passed in the House by an overwhelming vote of 407 to 17; that is, with about 96% of the votes cast in favor. This bill, along with the other bills, provided the foundation for the other titles of the JOBS Act.

And we know how this story turned out: as I noted just a few moments ago, the JOBS Act passed by overwhelming majorities in both houses and was signed into law by President Obama at a ceremony in the Rose Garden on April 5, 2012.

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[1] Available at: http://democrats.oversight.house.gov/images/stories/FULLCOM/510%20future%20of%20cap%20form/2011-03-22%20DEI%20to%20Schapiro-SEC%20-%20capital%20formation%20due%204-5.pdf.

[2] See http://www.treasury.gov/press-center/media-advisories/Pages/tg1111.aspx.

[3] Available at: http://www.wsgr.com/PDFs/rebuilding-IPO.pdf).

[4] Available at: http://www.govtrack.us/congress/bills/112/hr2930/text.

But, unfortunately, that's not really the end of the story. For despite the truly overwhelming support the JOBS Act commanded in Congress, including – as I noted a moment ago – the votes of every member of this Subcommittee, we know there are those who aren't happy with it, as demonstrated by the blistering editorial in THE NEW YORK TIMES[5] attacking the JOBS Act just before its passage. So it's worth asking how the SEC will discharge its responsibility to implement the JOBS Act.

In that regard, it's illuminating to re-read Chairman Schapiro's response[6] to that letter from Chairman Issa I referred to earlier – the one he sent back in March 2011. Chairman Schapiro's response was lengthy. It was professional. The SEC staff undoubtedly devoted a good deal of careful thought and effort when helping Chairman Schapiro to prepare it. But, unsurprisingly, the letter's principal message is consistent with that New York Times editorial almost a year later: regulation really hasn't been an impediment to capital formation and few, if any, changes were or are necessary or desirable, and certainly not with any urgency.

It's also illuminating to read Chairman Schapiro's March 13, 2012 letter to Chairman Johnson and Ranking Member Shelby of the Senate Committee on Banking, Housing and Urban Affairs stating her "concerns on some important aspects of" the then-pending JOBS Act.[7]

While in her letter Chairman Schapiro recognized that the legislation was "the product of a bipartisan effort designed to facilitate capital formation" and conceded that it included "certain promising approaches" that she did not specify, she went on to pan much of it, asserting that it would "weaken important protections," "remove certain important measures," "cause real and significant damage to investors," "undermine independent standard-setting," include changes that are "unwarranted,"

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[5] http://www.nytimes.com/2012/03/11/opinion/sunday/washington-has-a-very-short-memory.html.

[6] Available at: http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf.

[7] Available at: http://www.thevaluealliance.com/Schapiro_letter_Jobs_Act_031312.pdf.

cause investors to focus on materials "without important investor protections," and "adversely impact the IPO review program," among other criticisms.

In light of this letter, it's probably fair to conclude Chairman Schapiro is not a big fan of much of the JOBS Act, which – with the exception of the Merkley-Brown amendment – passed unchanged from the version on which Chairman Schapiro was commenting. And it's not too great a stretch to imagine that the SEC staff may generally share her distaste.

After all, the SEC had sufficient authority to do almost everything the JOBS Act did without any legislation at all. And because of the special expertise of the SEC and its staff, had it chosen to do so, it may have implemented approaches even more effective in facilitating capital formation – and the job creation that results – than those offered by the JOBS Act. Unfortunately, the JOBS Act was necessary precisely because the SEC did not believe in the need for what the JOBS Act seeks to accomplish.

This is not to suggest that the SEC won't implement the JOBS Act in a professional fashion. It will. But it is to suggest that the SEC, informed by the well-intentioned concerns of Chairman Schapiro and the SEC staff, could use the discretion given to it in rulemaking and interpretation to burden unnecessarily one or more of the provisions of the Act. And it is also possible that the SEC may assign the needed rulemakings a low priority, miss the congressionally mandated deadlines where they exist, and stretch out the period before the JOBS Act can become fully effective.

<u>Title I: The IPO On-Ramp</u>

Two titles of the JOBS Act, however, do not require SEC rulemaking. Title I provides an "IPO On-Ramp" designed to reduce the initial burdens of becoming a public company. Those who crafted Title I, led by the IPO Task Force, wisely made it self-executing. Even so, any new legislation inevitably gives rise to interpretive issues. And there also can be occasional circumstances in which the statutory language does not seem to match precisely with what quite evidently was the legislative intent. The JOBS Act is no different from any other legislation in this regard.

I'm pleased to report that to date the Division of Corporation Finance has done a good job navigating through the issues of this sort that have been identified in Title I. Perhaps the Division had its concerns about the wisdom of the legislation; certainly Chairman Schapiro did. But the Division has not sought potential opportunities to derail the operation of Title I. Instead, right from the start, the Division has issued thoughtful interpretations and FAQs in an effort to make Title I work as intended. The director, Meredith Cross, and the staff of the Division should be congratulated for their professional approach.

<u>Title V: Staying Private</u>

Title V (and the quite similar Title VI, which is targeted principally at the special case of community banks) also is self-executing and does not require new SEC regulations to become operative. Title V is designed to permit successful private companies to delay the burdens of becoming and being a public company for longer than previously possible by raising the maximum number of record holders of a class of equity securities (such as stock) a company may have without being required to register with the SEC. Title V raises the limit from 500 to 2,000, provided that no more than 500 holders are non-accredited investors. Title V also for the first time excludes employee stockholders from the count.

The tricky part of Title V for companies will be figuring out how to determine how many non-accredited record holders they have. The SEC or the staff is likely to provide guidance in this area in due course, and I urge you to encourage them to do so in a manner that renders these provisions workable and efficient.

Title II: Rule 506 and 144A Offerings Now May Use General Solicitation

The other titles of the JOBS Act do require SEC rulemaking. For example, Title II requires the SEC to revise its Rules 506 and 144A within 90 days of enactment which, according to my calculation, means July 4th is the deadline. In each case, the required revision is to permit general solicitation in connection with offerings under those rules.

The existing prohibition on general solicitation has two main elements. First, in connection with an affected offering, issuers and placement agents must not permit potential investors who are not qualified to participate to be exposed to the offering materials. Second, issuers and placement agents may contact only potential investors with whom they have pre-existing relationships, even if other investors are known to be qualified to participate. These prohibitions obviously make it harder to reach enough potential investors to make an offering a success.

Prohibitions on general solicitation have become quite controversial, in part because the modern interpretation of the First Amendment casts doubt on their constitutionality. For example, over a decade ago the Supreme Court struck down a Massachusetts law that banned cigarette advertising within 1,000 feet of a school or playground.[8] The Court ruled that the state's desire to prevent the exposure of minors to advertising for products minors are forbidden to purchase was insufficiently compelling to justify curtailing the rights of adults to make and receive commercial messages protected by the First Amendment. The question thus arises why the protection of adult non-accredited investors from advertising for unsuitable investments is more compelling than the protection of minors from addictive, cancerous products.

Be that as it may, Title II has now directed the SEC to lift the ban on general solicitation for offerings made in reliance on two often-used exemptions: Rule 506 and Rule 144A. The staff of the Division of

[8] *Lorillard* v. *Reilly*, 533 U.S. 525 (2001).

Corporation Finance has already addressed certain technical interpretive issues that will arise when the SEC rules are in place and done so in a thoughtful manner. So far, so good. But here's a possible problem: Title II states that the SEC's implementing rules must "require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission."

Under current market practice, the method generally used for determining whether purchasers qualify to participate in an exempt offering is self-certification: as part of the contract for the sale of the securities, each purchaser is required to represent and warrant that he, she or it meets the qualification standards to be, for example, an "accredited investor." Someone who is prepared to lie – and assume contractual liability for the lie – in order to get in on an offering has unclean hands and should deserve scant protection from the consequences of lying, so self-certification ought to be a sufficient "reasonable step" to verify that a purchaser is accredited. I urge you to encourage the SEC to confirm that self-certification suffices. And if the SEC insists on requiring anything extra, those additional or different requirements should not be unduly costly or uncertain in application.

And now is the time to get the new rules on the books without delay. As I noted earlier, the congressionally mandated deadline is July 4. The new rules will simply implement what Title II directs and, at least compared with many other rules, should be relatively straightforward to draft. I urge you to encourage the SEC to do so forthwith.

<u>Title III: Crowdfunding</u>

Title III of the JOBS Act authorizes crowdfunding. According to Wikipedia, crowdfunding may have gotten its start as a means for fans to fund the activities (such as tours) of musical groups that had not yet enjoyed sufficient commercial success to be self-funding. The idea was to harness the power of the internet as a nearly costless means of communication to pool modest sums from a large enough number of supporters that the resulting fund would be sufficient to enable the group's objective to be attained. The very low cost of solicitation of a large number of potential contributors made possible by the internet makes this approach work.

In its original form, Chairman McHenry's bill attempted to bring this same simplicity to the funding of small entrepreneurial ventures. But Title III picked up a number of additional provisions along the way to passage.

Unlike in Chairman McHenry's original bill, Title III now requires that an entrepreneur engage an intermediary to assist with the process. Although the required intermediary does not need to be an SEC-registered broker-dealer that is also a member of FINRA, the intermediary will still need to have registered with the SEC and joined FINRA, under new rules for such intermediaries yet to be written by the respective regulators.

And, as passed, Title III requires that intermediary (as well as the issuer and its key personnel) to accept a substantially more stringent liability standard – and hence greater risk -- than would be the case for other permissible forms of private financings. In my view, it would be ill-advised to assume such securities law liability without the advice of experienced securities counsel.

Moreover, as passed, Title III requires, even for an offering of less than $100 thousand, that investors be provided with financial statements certified by the principal executive officer. Those financial statements, of course, must be fully in accordance with US Generally Accepted Accounting Principles. So a competent accountant is required, an accountant prepared to accept – and be compensated for – the risks associated with being involved with a securities offering. And for offerings between $100 thousand and $500 thousand, that accountant must issue a review, and for offerings of greater amounts, the financial statements must be audited.

Not only that, but, as passed, Title III imposes an obligation to file with the SEC and provide to investors on-going reports no less frequently than annually, unless the SEC establishes exemptions from this requirement.

So the simple crowdfunding concept has now morphed into a conventional securities offering, with lawyers, accountants and financial intermediaries – plus on-going reporting requirements and also plus a liability standard significantly higher than would apply to other forms of exempt offerings, thereby meaningfully enhancing the risks to those third parties, and thus the compensation they will require for their services, if they are willing to offer their services at all.

The key question is: what percentage of the proceeds of a crowdfunded offering will all those intermediaries consume? If an entrepreneur in your district wants to use crowdfunding to raise $100 thousand (or $500 thousand or even the maximum $1 million) to start a small business, how much of that will the intermediary, the lawyer and the accountant together necessarily consume and how much will be left for use in the business? And how much of what remains available for use in the business will have to be reserved to fund the costs of the annual reporting obligations?

Individual circumstances will vary but, in my judgment, the likely answer often will be: not enough. If I'm right, crowdfunding could end up still-born.

By my count, Title III calls for SEC rulemaking to address more than fifteen separate matters, in addition to necessary rulemaking by FINRA. How all that rulemaking is crafted will help determine whether or not Title III assists in capital formation for small ventures or ends up as a dead letter, clogging the rule books to little effect.

In its rulemaking regarding Title III, the SEC in its cost-benefit analysis should, among other things, rigorously analyze the anticipated compliance costs associated with relying on Title III, including the costs for securities lawyers, accountants and registered intermediaries, as well as the present value of the costs of on-going reporting. In evaluating those costs, the SEC should include such items as the overhead costs an intermediary will bear to build and maintain a compliance infrastructure sufficiently robust to support and survive examination and inspection by the SEC and FINRA, and also give effect to the increased costs associated with addressing the heightened risks arising from the higher standard of liability Title III carries compared with other private offerings. The SEC should then determine the estimated fraction of the proceeds that would be consumed by those costs at various offering sizes within the permissible range allowed by Title III. If, after a rigorous cost analysis, in the judgment of the SEC those costs could render impractical the use of Title III for offerings below a certain dollar threshold or for all such offerings, it should plainly say so, so that Congress may then consider in an informed manner whether any additional legislative action is needed.

Finally, the deadline for SEC rulemaking is 270 days after enactment which, by my calculation, is December 31 of this year. In her letter to Chairman Johnson and Ranking Member Shelby, Chairman Schapiro stated that the bill's "time frame is too short" for SEC rulemaking. She asked for 18 months. Congress did not grant that request. While my experience as the SEC's general counsel has left me sensitive to the challenges facing the SEC in rulemaking, the priority assigned to a rulemaking project matters. I urge you to encourage the SEC to give these rulemakings high priority. Jumpstarting jobs is too urgent to delay.

Title IV: Super Reg. A

Title IV of the JOBS Act amends the SEC's Regulation A, creating what some have dubbed "Super Reg A" or, sometimes, "Reg A+". Early on, Representative Barney Frank, who at the time was Chairman of the House Financial Services Committee, stated that Regulation A reform would not be "partisan or terribly controversial," and indeed Title IV may be one of the least controversial sections of the JOBS Act.

Existing Regulation A offers an exemption from the otherwise applicable registration requirements of the Securities Act in the form of a scaled-back "mini-registration" process that does not lead to on-going reporting requirements. After the mini-registration, an issuer can sell to any investor and employ general solicitations in reaching potential investors. Regulation A, however, has been little used, principally because of the relatively low ceiling of $5 million that can be raised, which has proved too little in light of the costs of the mini-registration process and of the required compliance with the various securities laws of the 50 states, from which Regulation A does not provide preemption. Title IV is an attempt to make Regulation A potentially useful in offerings large enough to bear those costs by raising the ceiling to $50 million.

A prominent law firm has stated that the impact of Super Reg A "will depend in large part on how the SEC exercises its rulemaking authority to define the up-front and on-going obligations of companies that make use of the exemption."[9] I agree, and that means it's far from clear that Super Reg. A will be much used.

That's because Rule 506, as amended by Title II, may well remain substantially more attractive than Super Reg A. Importantly, as passed, Super Reg A, like crowdfunding in Title III, was burdened with a new, more stringent liability standard than applies to other forms of private offerings. That more stringent standard will increase the costs and risks of relying on Super Reg A. Rule 506 offerings remain subject to the usual liability standard. Moreover, Rule 506 offerings afford preemption of state securities law requirements, eliminating the potentially slow and costly process of working with regulators in 50 separate jurisdictions. Super Reg A doesn't, unless the company lists on an exchange. But listing on an exchange is nearly equivalent to conducting an IPO, something companies contemplating an exempt offering are, by definition, not yet

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[9] http://www.cgsh.com/files/News/3b1cdad1-c891-465d-934e-a8afa30a4ce1/Presentation/NewsAttachment/811aee8d-3c42-426f-91cc-abbb9052c371/Alert%20Memo%20-%20JOBS%20Act.pdf.

willing to undertake. Moreover, Rule 506 offerings do not require filings with the SEC and do not subject the company to on-going periodic disclosure requirements, something the SEC has discretion to impose in its Super Reg A rulemakings.

In short, Super Reg A benefits from the higher offering ceiling, but is burdened by other disadvantages and, in the worst case, could turn out to be used just as infrequently as old Reg. A. So I urge you to encourage the SEC in its rulemaking to minimize the costs and burdens to the greatest extent possible, in order to fulfill the Congressional intent of rendering Super Reg A offerings a useful and workable vehicle for capital formation by companies not yet ready or willing to undertake an IPO.

<u>Title VII: Outreach</u>

Title VII provides that the SEC "shall provide online information and conduct outreach to inform small and medium sized businesses ... of the changes made by this Act."

If you go to the SEC's home page[10] today, you'll see in a prominent position the only reference there to the JOBS Act, which says: "Notice: JOBS Act Crowdfunding Exemption." Clicking through takes you to the following:

> Information Regarding the Use of the Crowdfunding Exemption in the JOBS Act
>
> On April 5, 2012, the Jumpstart Our Business Startups (JOBS) Act was signed into law. The Act requires the Commission to adopt rules to implement a new exemption that will allow crowdfunding. Until then, we are reminding issuers that any offers or sales of securities purporting to rely on the crowdfunding exemption would be unlawful under the federal securities laws.[11]

[10] http://www.sec.gov.
[11] http://www.sec.gov/spotlight/jobsact/crowdfundingexemption.htm.

Also prominent on the home page is a link that takes you to a new page entitled "Spotlight on Topics of Current Interest at the SEC."[12] The "PCAOB Nomination Process" is on the list. Implementing the JOBS Act is not.

I urge you to encourage the SEC and its staff to devote sufficient resources to "getting the word out" in a form that can be understood by the entrepreneurs in your districts and across the nation as to how to avail themselves of the opportunities afforded by the JOBS Act. Major enterprises with large legal departments don't need this kind of assistance. Entrepreneurs do.

Conclusion

The JOBS Act was enacted with the overwhelming support of the Administration and both Houses of Congress. Important parts of the JOBS Act may succeed or fail depending on how they are implemented by the SEC. In our jobs-starved economy, time is of the essence. I thank you for focusing your congressional oversight on this critical topic.

I look forward to your questions.

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[12] http://www.sec.gov/spotlight.shtml.

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From 2006 to 2009, Mr. Cartwright was the 23rd General Counsel of the U.S. Securities and Exchange Commission. As SEC General Counsel, he was responsible for advising the Commission on all matters brought before it, including all enforcement actions and all rulemakings. Mr. Cartwright also supervised all cases litigated by the SEC in the United States Courts of Appeals and advised on all adjudications appealed to the Commission. During his service at the SEC, Mr. Cartwright was a senior advisor to the Chairman and other Commissioners and helped shape the Commission's major policy and regulatory initiatives.

Mr. Cartwright began his legal career in 1980 after earning a J.D. from Harvard Law School, where he was President of the *Harvard Law Review* and winner of the Sears Prize. He served as a law clerk to Judge Malcolm R. Wilkey of the United States Court of Appeals for the District of Columbia Circuit, and then as a law clerk to Associate Justice Sandra Day O'Connor of the United States Supreme Court. He was an associate at Latham & Watkins from 1982 to 1987 and became a partner in January 1988. During his time at Latham & Watkins, he served as Global Chair of the firm's Public Company Representation Practice Group and as a member of the firm's then five-member Executive Committee, among other management positions.

Mr. Cartwright's previous career was as an astrophysicist. Following his graduation from Yale University in 1967, he earned a Ph.D. in Physics from the University of Chicago in 1971. From 1973 to 1977 he was a Research Physicist at the Department of Physics and Space Sciences Laboratory of the University of California, Berkeley. During this time, he published numerous articles in scholarly journals in his field of high energy particle astrophysics.

Mr. Cartwright resides in Los Angeles with his wife Jean. They have three grown sons. Recently, Mr. Cartwright served as a technical advisor to Oliver Stone for the movie *Wall Street: Money Never Sleeps*.

Committee on Oversight and Government Reform
Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)(5)

Name:

1. Please list any federal grants or contracts (including subgrants or subcontracts) you have received since October 1, 2010. Include the source and amount of each grant or contract.

NONE.

2. Please list any entity you are testifying on behalf of and briefly describe your relationship with these entities.

NONE.

3. Please list any federal grants or contracts (including subgrants or subcontracts) received since October 1, 2010, by the entity(ies) you listed above. Include the source and amount of each grant or contract.

NONE.

I certify that the above information is true and correct.
Signature: Brian G. Cartwright

Date: June 22, 2012