Investor Protection is Needed for True Capital Formation

by

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Last week, the House of Representatives passed H.R. 3606, the "Jumpstart Our Business Startups Act." It is clear to me that H.R. 3606 in its current form weakens or eliminates many regulations designed to safeguard investors. I must voice my concerns because as an SEC Commissioner, I cannot sit idly by when I see potential legislation that could harm investors. This bill seems to impose tremendous costs and potential harm on investors with little to no corresponding benefit.

H.R. 3606 concerns me for two important reasons. First, the bill would seriously hurt investors by reducing transparency and investor protection and, in turn, make securities law enforcement more difficult. That is bad for ordinary Americans and bad for the American economy. Investors are the source of capital needed to create jobs and expand businesses. True capital formation and economic growth require investors to have both confidence in the capital markets and access to the information needed to make good investment decisions.

Second, I share the concerns expressed by many others that the bill rests on faulty premises. [1] Supporters claim that the bill would improve capital formation in the United States by reducing the regulatory burden on capital raising. However, there is significant research to support the conclusion that disclosure requirements and other capital markets regulations enhance, rather than impede, capital formation, [2] and that regulatory compliance costs are not a principal cause of the decline in IPO activity over the past decade. [3] Moreover, nothing in the bill requires or even incentivizes issuers to use any capital that may be raised to expand their businesses or create jobs in the U.S.

Professor John Coates of Harvard Law School has testified that proposals of the type incorporated into H.R. 3606 could actually hurt job growth:

> While [the proposals] have been characterized as promoting jobs and economic growth by reducing regulatory burdens and costs, it is better to understand them as changing … the balance that existing securities laws and regulations have struck between the transaction costs of raising capital, on the one hand, and the combined costs of fraud risk and asymmetric and unverifiable information, on the other hand. Importantly, fraud and asymmetric information not only have effects on fraud victims, but also on the cost of capital itself. Investors rationally increase the price they charge for capital if they anticipate fraud risk or do not have or cannot verify relevant information. Anti-fraud laws and disclosure and compliance obligations coupled with enforcement mechanisms reduce the cost of capital.

> … Whether the proposals will in fact increase job growth depends on how intensively they will lower offer costs, how extensively new offerings will take advantage of the new means of raising capital, how much more often fraud can be expected to occur as a result of the changes, how serious the fraud will be, and how much the reduction in information verifiability will be as a result of the changes.
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> Thus, the proposals could not only generate front-page scandals, but reduce the very thing they are being promoted to increase: job growth. [4]

Similarly, Professor Jay Ritter of the University of Florida has testified before the Senate banking committee that such proposals could in fact reduce capital formation:

> In thinking about the bills, one should keep in mind that the law of unintended consequences will never be repealed. It is possible that, by making it easier to raise money privately, creating some liquidity without being public, restricting the information that stockholders have access to, restricting the ability of public market shareholders to constrain managers after investors contribute capital, and driving out independent research, the net effects of these bills might be to reduce capital formation and/or the number of small [emerging growth company] IPOs. [5]

As drafted, H.R. 3606 would have significant detrimental impacts on the U.S. securities regulatory regime, including the following:

First, the bill will reduce publicly available information by exempting "emerging growth companies" from certain disclosure and other requirements currently required under the Federal securities laws. The bill's definition of "emerging growth company" would include every issuer with less than $1 billion in annual revenues (other than large accelerated filers and companies that have issued over $1 billion in debt over a three year period) for five years after the company's first registered public offering. [6] It is estimated that this threshold would pick up 98% of IPOs and a large majority of U.S. public companies for that five year period. [7]

An emerging growth company would only have to provide two years (rather than three years) of audited financial statements, and would not have to provide selected financial data for any period prior to the earliest audited period presented in connection with its initial public offering. It would also be exempt from the requirements for "Say-on-Pay" voting and certain compensation-related disclosure. Such reduced financial disclosure may make it harder for investors to evaluate companies in this category by obscuring the issuer's track record and material trends.

"Emerging growth companies" would also be exempt from complying with any new or revised financial accounting standards (other than accounting standards that apply equally to private companies), and from some new standards that may be adopted by the PCAOB. Such wholesale exemptions may result in inconsistent accounting rules that could damage financial transparency, making it difficult for investors to compare emerging companies with other companies in their industry. This could harm investors and, arguably, impede access to capital for emerging companies, as capital providers may not be confident that they have access to all the information they need to make good investment decisions about such companies.

Second, the bill would greatly increase the number of record holders a company may have, before it is required to publish annual and quarterly reports. Currently, companies with more than 500 shareholders of record are required to register with the SEC pursuant to Section 12(g) of the Securities Exchange Act and provide investors with regular financial reports. H.R. 3606 would expand that threshold to 2000 record holders (provided that, in the case of any issuer other than a community bank, the threshold would also be triggered by 500 non-accredited investors). Moreover, the bill would exclude from such counts any shareholders that acquire securities through crowdfunding initiatives and those that acquire securities as eligible employee compensation. Thus, a company could have a virtually unlimited number of record stockholders, without being subject to the disclosure rules applicable to public companies. [8] This effect is magnified by the fact that the reporting threshold only counts records holders, excluding the potentially unlimited number of beneficial owners who hold their shares in "street name" with banks and brokerage companies, and thus are not considered record holders.

This provision of the bill raises concerns because it could significantly reduce the number of companies required to file financial and other information. [9] Such information is critical to investors in determining how to value securities in our markets. Regular financial reporting enhances the allocation of capital to productive companies in our economy. [10]

Third, the bill would exempt "emerging growth companies" from Section 404(b) of the Sarbanes-Oxley Act, which requires the independent audit of a company's internal financial controls. Section 404(b) currently applies only to companies with a market capitalization above $75 million; companies below that threshold have never been subject to the internal controls audit requirement and were exempted from such requirement in the Dodd-Frank Act. The internal controls audit was established following the accounting scandals at Enron, WorldCom and other companies, and is intended to make financial reporting more reliable. Indeed, a report last year by Audit Analytics noted that the larger public companies, known as accelerated filers, that are subject to Section 404(b), experienced a 5.1% decline in financial statement restatements from 2009 to 2010; while non-accelerated filers, that are not subject to Section 404(b), experienced a 13.8% increase in such restatements. [11] A study by the SEC's Office of the Chief Accountant recommended that existing investor protections within Section 404(b) be retained for issuers with a market capitalization above $75 million. [12] With the passage of H.R. 3606, an important mechanism for enhancing the reliability of financial statements would be lost for most public companies, during the first five years of public trading.

Fourth, the bill would benefit Wall Street, at the expense of Main Street, by overriding protections that currently require a separation between research analysts and investment bankers who work in the same firm and impose a quiet period on analyst reports by the underwriters of an IPO. These rules are designed to protect investors from potential conflicts of interests. The research scandals of the dot-com era and the collapse of the dot-com bubble buried the IPO market for years. Investors won't return to the IPO market, if they don't believe they can trust it.

Fifth, H.R. 3606 would fundamentally change U.S. securities law, by permitting unlimited offers and sales of securities under Rule 506 of Regulation D (which exempts certain non-public offerings from registration under the Securities Act), provided only that all purchasers are "accredited investors". The bill would specifically permit general solicitation and general advertising in connection with such offerings, obliterating the distinction between public and private offerings.

This provision may be unnecessary. A recent report by the SEC's Division of Risk, Strategy and Financial Innovation confirms that Regulation D has been effective in meeting the capital formation needs of small businesses, with a median offering size of $1,000,000 and at least 37,000 unique offerings since 2009. [13] Regulation D offerings surpassed $900 billion in 2010. The data does not indicate that users of Regulation D have been seriously hampered by the prohibition on general solicitation and advertising.

I share the concerns expressed by many that this provision of H.R. 3606 would be a boon to boiler room operators, Ponzi schemers, bucket shops, and garden variety fraudsters, by enabling them to cast a wider net, and making securities law enforcement much more difficult. Currently, the SEC and other regulators may be put on notice of potential frauds by advertisements and Internet sites promoting "investment opportunities." H.R. 3606 would put an end to that tool. Moreover, since it is easier to establish a violation of the registration and prospectus requirements of the Securities Act than it is to prove fraud, such scams can often be shut down relatively quickly. H.R. 3606 would make it almost impossible to do so before the damage has been done and the money lost.

In addition others have noted that the current definition of "accredited investor" may not be adequate and that the requirement that purchasers be accredited investors would provide limited protection. [14] For example, an "accredited investor" retiree with $1 million in savings, who depends on that money for income in retirement, may easily fall prey for a "hot" offering that is continually hyped via the internet or late night commercials.

These are just a few observations regarding H.R. 3606. It also includes other provisions that require substantial further analysis and review, including among other things the so-called crowdfunding provisions. [15]

The removal of investor protections in this bill are among the factors that have prompted serious concerns from the Council of Institutional Investors, AARP, the North American Securities Administrators Association, the Consumer Federation of America, and Americans for Financial Reform, among others. [16]

Questions Re: H.R. 3606

As H.R. 3606 is considered, the following is a non-exhaustive list of questions that should be addressed:

1. The bill would define "emerging growth company" as any company, within 5 years of its IPO, with less than $1 billion in annual revenue, other than a large accelerated filer or a company that has issued $1 billion in debt over a three-year period.

- What is the basis for the $1 billion revenue trigger?
- Why is revenue the right test? Why is $1 billion the right level?
- It has been estimated that this definition would include 98% of all IPOs, and a large majority of all public companies within the 5-year window. Was such a broad scope intended?

2. As provided in the bill, financial accounting standards, auditing and reporting standards, disclosure requirements, and the period for which historical financial statements is required, could all differ as between "emerging growth companies" and all other public companies – including all companies that went public before December 8, 2011.

- How will these differences affect the comparability of financial reporting for these two classes of issuers?
- Will reduced transparency, or lack of comparability, affect the liquidity of emerging growth companies?
- Will reduced transparency or reduced liquidity affect the cost of capital for emerging growth companies? Will investors demand a "discounted price" to offset any perceived higher risk resulting from reduced disclosures and protections?

- Will emerging growth companies be required to include risk factors or other disclosure in their registration statements and other filings, regarding transparency, comparability and any potential effects thereof?

3. The bill would expand the threshold for the number of shareholders an issuer may have, before it is required to file annual and other reports under Section 12(g) of the Exchange Act, from 500 to 2000 (of which no more than 500 may be non-accredited investors, for issuers other than community banks), and would exclude from such counts shareholders that acquire securities through crowdfunding initiatives and those that acquire securities as eligible employee compensation.

- How was the new threshold of 2000 holders determined?
- Is that the right threshold for determining whether the public interest in such securities justifies regulatory oversight?
- How many companies would be exempted from registration and reporting by the bill?
- When shares are held in "street name" the number of beneficial owners may greatly exceed the number of record holders. How will the new threshold of 2000 record holders be applied in such cases?[17]
- How would the exclusion of employees and crowdfunding purchasers be applied, if such holders transfer their shares to other investors? How would this be tracked?

4. To the extent the bill results in reduced transparency and/or reduced liquidity for emerging growth companies, or for companies exempted from Exchange Act reporting by the new thresholds under Section 12(g), such results may impact investment decisions by institutional investors.

- How would mutual fund managers, pension fund administrators, and other investors with fiduciary duties address such reduced transparency or lack of liquidity in making investment decisions?
- Could reduced transparency or reduced liquidity impact the ability of fund managers to meet applicable diversification requirements?
- Could such effects cause managers to increase concentration into fewer US reporting companies? How would such concentration affect market risk? Would the bill result in investor funds being redirected to companies overseas?

5. The bill is being promoted as a jobs measure, on the grounds that reducing regulation will improve access to capital for small and emerging businesses, allowing them to grow and add employees.

- What is the evidence that regulatory oversight unduly impedes access to capital?
- What is the evidence that companies that are otherwise prepared to grow (that is, they have the appropriate business model, management team, and aspirations) are prevented from growing by an inherent lack of access to potential sources of capital?
- I understand that the costs of complying with regulatory requirements are a factor underpinning H.R. 3606. How do such costs compare to other costs of raising capital, such as investment banking fees? How do such costs compare to other administrative costs? If reduced

transparency, lack of comparability, and other consequences of the bill result in a higher cost of capital for emerging growth companies, will the money saved on compliance be worth it?

6. Evidence shows that the public companies that are currently exempt from internal controls audit requirements have a higher incidence of financial reporting restatements, and that companies that have restated their financial results produce substantially lower returns for investors. [18]

- How do any perceived benefits from H.R. 3606's exemption of emerging growth companies from the audit of internal controls compare to the likelihood of increased restatements? Would an increase in restatements hamper capital formation?

- Will the lack of an internal controls audit result in greater financial and accounting fraud?

7. The bill requires the Commission to revise its rules to provide that the prohibition against general solicitation or general advertising contained in Regulation D shall not apply to offers and sales of securities pursuant to Rule 506, provided that all purchasers are accredited investors.

- Given the success of Regulation D as a capital raising mechanism, including its successful use by small and emerging companies,[19] is there any evidence that general solicitation and general advertising are necessary for capital formation?

- Given the current definition of "accredited investor", is that the right test for determining who issuers may target, in offers made by general solicitation or advertising?

Conclusion

H.R. 3606 would have a significant impact on the capital markets and raises many questions that have yet to be satisfactorily resolved. I have yet to see credible evidence that justifies the extensive costs and potential harm to investors this bill may impose.

I urge Congress to undertake the review necessary to resolve these questions, and to ensure that investors, as the providers of the capital that companies need to grow and create jobs, have the protections they need and deserve.

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[1] *See*, *e.g.*, Andrew Ackerman and Lynn Cowan, *Jobs Bill Loosens IPO Regulations*, The Wall Street Journal (March 8, 2012), quoting Barbara Roper of the Consumer Federation of America, "no realistic promise that it will create jobs"; Jesse Hamilton and Phil Mattingly, *Job-Creating Bill Seen Eviscerating U.S. Shareholder Protections*, Bloomberg, March 13, 2012, http://www.bloomberg.com/news/2012-03-13/job-creation-legislation-seen-eviscerating-shareholder-protections-in-u-s-.html, quoting Representative John P. Sarbanes that the bill could lead to an "Enron-Type fraud."; John Wasik, *JOBS Act Will Open Door to Investment Scams*, Forbes, March 14, 2012, *available at* http://www.forbes.com/sites/johnwasik/2012/03/14/jobs-act-will-open-door-to-investment-scams/ quoting Jack Herstein, President of the North American Securities Administrators Association, "While well intentioned, the JOBS Act approved by the House sacrifices essential investor protections without offering any prospects for meaningful, sustainable job growth."; Kathleen Pender, *Financial Regulations Gutted in New Bill*, The San Francisco Chronicle, March 11, 2012, *available at* http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2012/03/10/BUPU1NIGVF.DTL, quoting Arthur Levitt, former Chairman of the Securities and Exchange Commission, "This bill is a

disgrace."

[2] *See*, *e.g.*, Frank B. Cross and Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 Cardozo L. Rev. 333 (2006). *See*, *also*, Luis A. Aguilar, Comm'r, U.S. Securities and Exchange Commission, Speech at the Council of Institutional Investors Spring Meeting: Facilitating Real Capital Formation (April 4, 2011), www.sec.gov/news/speech/2011/spch040411laa.htm#P64_30599, notes 24-26; but *cf id*., note 20. For the effects of information asymmetry on capital formation, see, George A. Akerlof, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism*, The Quarterly Journal of Economics (August 1970) (demonstrating that a lack of adequate information about the quality of an item being purchased can drive a market out of existence: "There may be potential buyers of good quality products and there may be potential sellers of such products in the appropriate price range; however, the presence of people who wish to pawn bad wares as good wares tends to drive out the legitimate business. The cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost also must include the loss incurred from driving legitimate business out of existence."). Numerous studies speak to the benefits that investor protection brings to capital formation. For example, a 2003 study showed that enhanced financial disclosures and analysis in filings under the Securities Exchange Act resulted in more accurate and informed share prices, which contributes to a better functioning real economy. Merritt B. Fox, Randall Morck, Bernard Yeung, and Artyom Durnev, *Law, Share Price Accuracy, and Economic Performance: The Empirical Evidence*, 102 Mich. L. Rev. 331 (2003). The conclusion that more accurate and informed share prices contribute to the real economy references Jeffrey Wurgler, *Financial Markets and the Allocation of Capital*, 58 J. Fin. Econ. 187 (2000) and Artyom Durnev et al., *Value Enhancing Capital Budgeting and Firm-specific Stock Return Variation*, 58 J. Fin. 64 (2004). *Id*. notes 86 and 87. A 2006 study found that the Exchange Act amendments of 1964, which extended disclosure requirements to over-the-counter companies, created substantial value for the shareholders of such companies. Michael Greenstone, Paul Oyer, and Annette Vissing-Jorgensen, *Mandated Disclosure, Stock Returns and the 1964 Securities Acts Amendments*, Quarterly Journal of Economics, May 2006 (stating that the "results imply that the 1964 Amendments created … $3.2 to $6.2 billion [,measured in 2005 dollars], of value for stockholders"). A summary version of the paper is available at http://www.stanford.edu/group/siepr/cgi-bin/siepr/?q=system/files/shared/pubs/papers/briefs/policybrief_jan06.pdf. *See also*, Allen Ferrell, *Mandated Disclosure and Stock Returns: Evidence from the Over-the-counter Market*, 36 J. Legal Studies 1 (2007). An earlier draft is the John M. Olin Center for Law, Economics, and Business Discussion Paper No. 453 (December 2003). http://www.law.harvard.edu/faculty/fferrell/pdfs/Ferrell-MandatedDisclosure2.pdf.

[3] *See*, *e.g*., statement of Professor Ritter, *infra*, note 5, at pp 3-5, and statement of Professor Coffee, *infra*, note 15, at pp 1-3.

[4] Testimony of Professor John C. Coates IV, John F. Cogan, Jr. Professor of Law and Economics, Harvard Law School, before the Subcommittee on Securities, Insurance, and Investment of the Committee on Banking, Housing, and Urban Affairs, United States Senate, on *Examining Investor Risks in Capital Raising* (December 14, 2011), at 2.

[5] Statement of Professor Jay R. Ritter, Cordell Professor of Finance, University of Florida, before the Senate Committee on Banking, Housing, and Urban Affairs on Spurring Job Growth Through Capital Formation While Protecting Investors, Part II (March 6, 2012), at 8. http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=a5ded25c-135d-484a-943a-bfa52fba3206.

[6] As drafted, an issuer that goes public "through the back door", without ever selling common equity securities pursuant to an offering registered under the Securities Act, could conceivably remain an "emerging growth company" forever.

[7] Statement of Lynn E. Turner before the Senate Committee on Banking, Housing, and Urban Affairs on *Spurring Job Growth Through Capital Formation While Protecting Investors*, Part II (March 6, 2012), at 12, citing Audit Analytics. http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=5aaabb66-36eb-4b1e-8195-3cbeda832814.

[8] Exchange Act reporting is also required for companies listed on a national securities exchange, as well as companies that have filed an effective registration statement under the Securities Act (provided that, after the fiscal year in which such registration statement becomes effective, the company has at least 300 shareholders of record). Significantly, the bill would raise the 300 shareholder threshold for "going dark" to 1200 shareholders, for bank holding companies.

[9] An editorial published today by John Coates, Professor of Law and Economics at Harvard Law School, estimates that "[m]ore than two-thirds of all public companies would be exempt under the bill's new criterion." *See*, John Coates and Robert Pozen, *A Regulatory Bill that Cuts Investor Protections*, The Washington Post, March 16, 2012, available at http://www.washingtonpost.com/opinions/bill-to-help-businesses-raise-capital-goes-too-far/2012/03/13/gIQAVWgFCS_story.htm

[10] *Id*.

[11] Tammy Whitehouse, Restatements by Small Companies Could Revive SOX 404 Debate, Compliance Week (May 24, 2011), http://www.complianceweek.com/restatements-by-small-companies-could-revive-sox-404-debate/article/203211/.

[12] Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between $75 and $250 Million (April 2011). http://www.sec.gov/news/studies/2011/404bfloat-study.pdf. This study was required pursuant to section 989G(b) of the Dodd-Frank Act. The GAO is required to conduct a study of the impact of the exemption provided by Section 989G(a), which is due three years after enactment of the Dodd-Frank Act.

[13] Vlad Ivanov and Scott Baugess, Capital raising in the U.S.: The significance of unregistered offerings using

the Regulation D exemption (December 5, 2011).

[14] *See*, John Coates and Robert Pozen, *A Regulatory Bill that Cuts Investor Protections*, The Washington Post, March 16, 2012, *available at* http://www.washingtonpost.com/opinions/bill-to-help-businesses-raise-capital-goes-too-far/2012/03/13/gIQAVWgFCS_story.htm.

[15] Professor Coffee of Columbia Law School has called such crowdfunding provisions "The Boiler Room Legalization Act of 2011". Statement of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School, at Hearings Before the Senate Committee on Banking, Housing and Urban Affairs, "*Spurring Job Growth Through Capital Formation While Protecting Investors*" (December 1, 2011) Washington, D.C., p.1, http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=d580503c-a7f3-4db5-b9f5-968d03af374f.

[16] *See*, *e.g.*, letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to Hon. John Boehner, Speaker, and Hon. Nancy Pelosi, Minority Leader, U.S. House of Representatives (March 7, 2012), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2012/03-07-12%20-%20Council%20letter%20to%20House%20on%20Cap%20Formation%20Bill%20(FINAL).pdf; Kathleen Pender, *Financial regulations gutted in new bill*, San Francisco Chronicle (March 11, 2012), D-1, *available at* http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2012/03/10/BUPU1NIGVF.DTL; letter from Jack E. Herstein, NASAA President and Assistant Director, Nebraska Department of Banking & Finance, Bureau of Securities, to Hon. Harry M. Reid, Majority Leader, and Hon. Mitch McConnell, Minority Leader, United States Senate (March 12, 2012); CFA Urges Pro-Investor, Pro-Market Changes to the JOBS Act (H.R. 3606) (March 12, 2012), http://www.consumerfed.org/news/472; Statement of CFA Director of Investor Protection Barbara Roper In Response to House Passage of Anti-Investor, Anti-Jobs JOBS Act (March 8, 2012), http://www.consumerfed.org/news/470; and letter from Americans for Financial Reform, Consumer Federation of America and other signatories to Hon. Timothy Johnson, Chairman, and Hon. Richard Shelby, Ranking Member, Committee on Banking, Housing and Urban Affairs, United States Senate (March 5, 2012), http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2012/03/Public-Interest-Senate-Capital-Formation-Bills-Letter-3-5-12.pdf.

[17] *See*, Coffee testimony, note 10, *supra*, at 1, "Of even greater concern to me is the overbreadth inherent in S.1824 [the Senate version of H.R. 2167, which became Title V of H.R. 3606], which pushes up the threshold at which an issuer must become a "reporting company" and make periodic disclosures to the market to 2,000 shareholders of record. I can understand the case for increasing the threshold under Section 12(g), but the problem with the approach taken is that record ownership is easily manipulated and companies could come to have 5,000 or more beneficial shareholders (and billions in stock market capitalization) without becoming subject to the increased transparency of the Securities and Exchange Act of 1934. There is no need for such an open-ended exemption (largely benefitting larger firms) or for such a dramatic retreat from the principle of transparency that has long governed our securities markets in order to spur job creation at smaller firms."

[18] *See, e.g.,* Whitehouse article, note 11, *supra*, and Turner testimony, note 7, *supra*, at pp 16-19.

[19] *See*, note 13, *supra*, and accompanying text.

http://www.sec.gov/news/speech/2012/spch031612laa.htm

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