Written Testimony of William Beatty

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House Committee on Financial Services

Subcommittee on Capital Markets and Government Sponsored Enterprises

*Hearing on "Legislative Proposals to Enhance Capital Formation for Small and Emerging Growth Companies, Part II"*

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## Introduction:

Good Morning Chairman Garrett, Ranking Member Maloney, and members of the Subcommittee. My name is Bill Beatty. For the past 28 years, I have worked as an attorney in the Securities Division of the Washington State Department of Financial Institutions, and since 2010 I have served as the Department's Securities Director. I am also the President-Elect of the North American Securities Administrators Association, Inc. ("NASAA"),[1] the association of state and provincial securities regulators. Prior to my election to be NASAA President, I served as the Chairman of NASAA's Corporation Finance Section, and as a member of NASAA's Special Committee on Small Business Capital Formation.

I am honored to testify before the Subcommittee today about legislative proposals to enhance capital formation for small and emerging growth companies.

State securities regulators have protected Main Street investors for the past 100 years, longer than any other securities regulator. Ten of my colleagues are appointed by Secretaries of State, five are under the jurisdiction of their states' Attorneys General. Some, like me, are appointed by their Governors and Cabinet officials and some of my colleagues work for independent commissions or boards. We are responsible for enforcing state securities laws by pursuing cases of suspected investment fraud, conducting investigations of unlawful conduct, licensing firms and investment professionals, registering certain securities offerings, examining broker-dealers and investment advisers, and providing investor education programs and materials to your constituents.

States are also the undisputed leaders in criminal prosecutions of securities violators. In 2012 alone, state securities regulators conducted nearly 6,000 investigations, leading to nearly 2,500 enforcement actions, including 339 criminal actions. Moreover, in 2012, 4,300 licenses of brokers and investment advisers were withdrawn, denied, revoked, suspended, or conditioned due to state action. State securities regulators continue to focus on protecting retail investors, especially those who lack the expertise, experience, and resources to protect their own interests.

In addition to serving as "cops on the beat" and the first line of defense against fraud, state securities regulators serve as the primary regulators of most small size offerings. As such, state securities regulators regularly work with and assist small and local businesses seeking investment capital. Moreover, state securities regulators, acting within NASAA, have a long history of working closely with the U.S. Securities and Exchange Commission ("SEC" or "Commission") to affect greater uniformity in federal-state securities matters, including meeting annually as required by section 19(d) of the Securities Act of 1933.

State securities regulators share Congress' desire to improve the United States economy by, spurring private investment for small businesses. However, we believe this goal is best achieved through restoring investor confidence in the markets and market participants, and it is our hope that

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[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc. (NASAA) was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

Congress and the state securities regulators can work together to pursue balanced and sensible policy reforms that reflect smarter regulation.

## State Regulators and Small Business Capital Formation

State regulators provide a level of accessibility to local small business issuers and investors that is unavailable from the Commission. For example, the Washington Securities Division routinely presents to entrepreneurs, small business development centers, and other local groups regarding vital information that businesses need to know if they are contemplating raising capital. We provide this assistance through all stages of a growing company's business operations, from formation through the issuance of securities, and helps to ensure that small businesses have access to the capital needed to start or grow their business in a manner consistent with both state and federal regulations.[2]

State securities regulators are accountable to residents of their states, including both investors and local businesses that seek to raise capital. This accountability factors into our review of applications for registration, including the adequacy of disclosures to prospective investors. We must answer questions from investors, businesses, local legislators, and the local media regarding offerings that have been registered, as well as those that have not been granted registration. Such a level of accountability is essential to investor protection in these smaller public offerings.

### States Are Leaders in Modernizing Capital Formation

My testimony today discusses in considerable detail the important role states play in protecting retail investors, working with emerging and local businesses to help them raise investment capital, and providing oversight of small sized offerings. However, at the outset of my testimony, I would like to address one of the apparent themes running through a number of the bills before the Subcommittee today, which is the notion that federal preemption of state law is the most direct and expeditious way to promote capital formation. As state securities regulators have testified in the past, and as I believe the implementation of the JOBS Act has perhaps underscored, this is simply not true.

Two areas where states have undertaken actions that illustrate this point relate to legislation pending before the Subcommittee today. While I discuss this more extensively later in my testimony , I want to state at the outset that these serve as concrete examples of states' initiative and capability, and of the potentially severe and counterproductive impact of federal preemption.

#### *(1) Crowdfunding*

One of the discussion drafts before the Subcommittee today would make substantial revisions to the federal exemption for crowdfunding, enacted under Title III of the JOBS Act.

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[2] For example, a group of local businesspersons from a small town in Washington contacted our staff to discuss requirements for raising capital before filing with the Division. Our staff regularly corresponded with these individuals and when they subsequently filed their application for registration, our staff reviewed the company's offering materials to ensure that all material information was disclosed and that the offering was not abusive of investors. We registered the offering within three months of filing the application and the company successfully raised over $650,000 from Washington investors. It is doubtful that this issuer would have received the same level of support and attention from Commission staff in Washington, D.C.

As some members of the Subcommittee may recall, on September 13, 2011, NASAA testified that states should be permitted to play the leading role in establishing a new marketplace for raising capital through crowdfunding.[3] Congress disagreed, and in March of 2012, enacted a federal crowdfunding bill that broadly preempted state authority.

At the time the JOBS Act was enacted, NASAA was in the midst of promulgating a model crowdfunding exemption. The NASAA model exemption, which was drafted by a NASAA committee comprised of regulators from seven states, and on which I served, was broadly supported by state regulators.[4] In December 2012, NASAA estimated that the model rule was on course to likely be finalized and adopted by the third quarter of 2012.[5]

The enactment of the JOBS Act unfortunately precluded the states from playing a leading role in crowdfunding; following enactment of the law work on the NASAA model rule was deferred. Nevertheless, as I appear before you today, seven states have adopted crowdfunding exemptions under the intrastate offering exemption of the Securities Act of 1993, and more than a dozen other states are actively considering adopting exemptions to facilitate crowdfunding. *Such actions demonstrate decisively that, had Congress allowed the states to proceed with our efforts, there would be an emerging, vibrant, and functioning crowdfunding market operating today.*

***(2) Regulation A+***

A second discussion draft before the Subcommittee addresses Regulation A Plus, which, like crowdfunding, is awaiting the completion of rulemaking by the SEC.

During Congress' consideration of the JOBS Act, state securities regulators urged Congress to preserve the states' role as primary overseers of Regulation A offerings. Congress concurred, and NASAA agreed to support a proposed Government Accountability Office ("GAO")[6] study of impediments

[3] Testimony of A. Heath Abshure, Arkansas Securities Commissioner and Chairman of the Corporation Finance Section Committee North American Securities Administrators Association, Inc. before the House Subcommittee on Capital Markets and Government Sponsored Enterprises at a hearing entitled "Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation." September 21, 2011.
http://financialservices.house.gov/uploadedfiles/092111abshure.pdf

[4] As then-NASAA President Jack Herstein explained in a letter to House Financial Services Committee: "*On October 18 [2011], NASAA's Board of Directors met in Washington and voted to establish a special Small Business Capital Formation Committee to examine and propose steps that may be taken collectively by state securities regulators to promote and facilitate the formation of small business capital. I have directed that the Committee's first order of business be the development of initiatives, including a model rule, which state securities regulators may adopt to responsibly encourage small business capital formation through crowdfunding… In the case of crowdfunding, state securities regulators are not only capable of acting, but indeed, are acting, and Congress should allow them the opportunity…"* See Letter from NASAA President Jack Herstein to the Chairman and Ranking Member of the House Financial Services Committee. October 21, 2011. http://www.nasaa.org/wp-content/uploads/2011/07/2930_Letter102111.pdf

[5] When the JOBS Act was enacted on April 5, 2012, NASAA's model crowdfunding rule was in the midst of an internal comment period. Following the completion of such comment period, the model would have been posted for public comment for a period, after which a final rule could have been adopted by NASAA.

[6] U.S. GOV'T ACCOUNTABILITY OFFICE, SECURITIES REGULATION: FACTORS THAT MAY AFFECT TRENDS IN REGULATION A OFFERINGS, GAO-12-839 (2012).

to the use of Regulation A, and committed to undertake concrete steps to address any impediments associated with Blue Sky laws.

Consistent with our desire to promote capital formation in our communities and our pledge to Congress to promptly undertake steps to remedy inefficiencies in the state processes for reviewing Regulation A offerings, state securities regulators conducted a thorough self-assessment of existing state processes and examined the concerns expressed in the GAO's study of offerings conducted under current Regulation A. In 2013, NASAA commenced a year-long effort to address inefficiencies in the state review process while continuing our essential mandate of protecting investors. As part of this process, NASAA consulted numerous stakeholders, and solicited public comments.[7]

The culmination of the states' effort to modernize our processes for reviewing Regulation A offerings is the NASAA Coordinated Review Protocol.[8]

Under the new Protocol, Regulation A filings will be made in one place and distributed electronically to all states, and "lead" examiners will be appointed as the primary point of contact for both the disclosure and merit review states. Each state in which registration is sought is permitted ten business days to review an application for registration and submit comments or concerns to the lead examiners, but the lead examiners alone will interact with the issuer to resolve any deficiencies, streamlining the process Importantly, once a lead examiner clears the application, the decision is binding on all other states.

The NASAA Coordinated Review Protocol has been approved by the NASAA membership and 49 of 53 NASAA jurisdictions have implemented the Protocol by signing the requisite memorandum. We are excited about the new Protocol, and its potential to help small and emerging businesses in our communities.

In short, with respect to the implementation of Regulation A Plus, the states are ready-to-go, provided that Congress and the SEC don't short-circuit our efforts by preempting our role.

## NASAA Comments on Three Legislative Proposals Before the Subcommittee

The Subcommittee has requested that NASAA comment on three draft legislative proposals intended to promote capital formation and reduce unnecessary regulatory burdens, and NASAA's views regarding the impact (or lack thereof) that the enactment of such proposals may have on the economy and the capital markets. The three proposal are: (1) discussion draft legislation proffered by Representative Patrick McHenry of North Carolina entitled "The Startup Capital Modernization Act of 2014"; (2) discussion draft legislation proffered by Rep. McHenry entitled "The Equity Crowdfunding Improvement Act of 2014"; and (3) a discussion draft, without an identified sponsor, "to direct the

[7] In designing the Coordinated Review Program and its protocols, members of NASAA's Small Business/Limited Offerings Project Group met with and collected feedback from the American Bar Association's Business Law Section's working group on Section 3(b)(2) offerings. We also engaged and received detailed comment from stakeholders such as the Biotechnology Industry Organization (BIO).

[8] The full text of the NASAA Multi-state Coordinated Review Protocol may be found on the NASAA website at www.nasaa.org. Please see Addendum #1 for an illustrated guide outlining the NASAA Multi-state Coordinated Review Protocol.

Securities and Exchange Commission to revise its proposed amendments to Regulation D, Form D, and Rule 156, as contained in Release Number 33-9416."

State securities regulators are broadly concerned about the overarching deregulatory nature of these proposals, the primary impact of which would be to weaken various federal securities laws and reduce state and federal oversight of initial public offerings and small public companies. While we wholeheartedly share the Subcommittee's stated goal of promoting capital formation, assisting small businesses, and spurring economic growth, we believe that many aspects of the drafts before the Subcommittee today would shift policies in the wrong direction. Over-regulation did not cause our financial markets to collapse. A weakened regulatory system has not contributed to our capital market system being viewed as the "gold" standard. Investor confidence in our system is what fuels economic growth and job creation.

## I. Comments on Discussion Draft Legislation entitled "The Startup Capital Modernization Act of 2014"

The overall impact of the Startup Capital Modernization Act of 2014 would substantially and further weaken investor protections, in several important ways.

### ***Preemption of State Authority to Review Regulation A Offerings***

Securities offerings must either be registered with the appropriate government authorities or be subject to an available exemption from the registration requirement. Offerings under federal Regulation A have long been capped at $5 million. Title IV of the JOBS Act directed the SEC to adopt rules to provide an exemption from the registration process for certain offerings up to $50 million. Due to its similarity to the current Regulation A, this new exemption is commonly referred to as Regulation A+. These offerings will be exempt from SEC registration under the new Section 3(b)(2) of the Securities Act of 1933, but will be subject to registration at the state level unless listed on a national securities exchange or sold to "qualified purchasers" as that term is defined by the Commission.

The proposed Startup Modernization Act would raise the offering limit of "traditional" Regulation A from $5 million to $10 million and expand the scope of possible state preemption.

Given the inherently risky nature of the offerings, and the primacy of the states' role in policing small offerings, NASAA believes that state oversight is critically important for investor protection and responsible capital formation. As I recently explained in a comment letter filed with the Commission regarding Regulation A offerings:

> State regulation [of Regulation A offerings] is essential to capital formation and investor protection in these offerings. Given the relatively small size of these offerings and the low probability of attracting the attention of national broker-dealers to distribute them, these offerings are likely to be local in nature. Companies that are successful in raising funds in Regulation A offerings will likely be raising funds from local investors who have some level of familiarity with the company and/or its promoters.
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> State regulators provide a level of accessibility to local small business issuers and local investors that is unavailable from the Commission. In addition to responding to inquiries from local investors questioning the legitimacy of offerings, state regulators regularly field inquiries from

entrepreneurs, small business owners, and local counsel regarding options for raising capital. We are easily accessible via telephone, e-mail, and even provide in-person consultations. This assistance is provided through all stages of business operations, from formation through issuance.[9]

At the same time, state securities regulators also understand that that dealing with multiple states may be burdensome for some small companies. As explained above, over the past 18 months, in anticipation of the SEC's implementation of Title IV of the JOBS Act, states, working within the framework of NASAA, have successfully undertaken unprecedented steps to modernize and streamline our processes for reviewing Regulation A offerings.

State regulators want offerings under the new Regulation A+ to be an attractive alternative to offerings conducted under Rule 506 of Regulation D. Although the GAO did not single out Blue Sky laws as the sole or even the primary reason for disuse of Regulation A,[10] we recognize that Regulation A+ will involve larger and more broadly dispersed offerings that elevate the need for uniformity in the states' rules. [11] For that reason, NASAA undertook a year-long effort to address and respond to the points raised in the GAO report. The result was a new coordinated filing and review program created with active industry input.

The states embraced this opportunity for change and modernization and voted overwhelmingly in March to support the NASAA Coordinated Review Program for Regulation A offerings. Within three weeks of approving the program, nearly all U.S. NASAA members officially signed a Memorandum of Understanding demonstrating their agreement to participate, signaling broad support for the program.

NASAA will continue to work with all of its U.S. members over the coming weeks to secure additional approvals and to deploy the program so that issuers may begin realizing its benefits.

The Coordinated Review Program for Regulation A offerings will provide greater efficiencies in the state review process, maintain important investor protections, and facilitate responsible capital formation.

***NASAA's Coordinated Review Program for Regulation A offerings***

With the potential for more Regulation A offerings as a result of the JOBS Act, we understand that the creation of an efficient filing and review process for multi-state securities offerings is critical. NASAA has designed and is ready to implement a streamlined multi-state review program for Regulation A filers. Key features of this process include:

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[9] Comment letter from William Beatty. Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act; Release Nos. 33-9497, 34-71120, 39-2493; File No. S7-11-13). March 24, 2014. http://www.sec.gov/comments/s7-11-13/s71113-76.pdf

[10] According to the GAO Report, "Multiple factors appear to have influenced the use of Regulation A[, including] the type of investors businesses sought to attract, the process of filing the offering with SEC, state securities laws, and the cost-effectiveness of Regulation A relative to other SEC exemptions." Id.

[11] United State Government Accountability Office Report to Congressional Committees, Securities Regulation: Factors That May Affect Trends in Regulation A Offerings, July 2012.

- The program coordinator will be the State of Washington. Issuers desiring coordinated review will email an electronic copy of the application and required exhibits to Washington.
- The program coordinator will distribute the documents to states selected by the issuer on the application form.
- An electronic filing system is under development and is scheduled to be available for Rule 506 offerings in November of this year. Once operational, the system will be expanded to accommodate Regulation A and other filings. This one-stop electronic filing system will take the place of the email based system described above.
- Timelines for review:
    - Within three days after receipt of the application the program coordinator will select two lead examiners—one for merit review and one for disclosure review.
    - No later that ten business days after the lead examiners are selected, they will drat and circulate a proposed comment letter to the other participating states.
    - The participating states the have 5 business days to communicate any suggested changes to the lead examiners.
    - Within an additional 3 business days, the lead examiners will finalize the initial comment letter and send it to the issuer. If there are no comments, the offering will be cleared, 21 business days after filing.
    - If there are outstanding deficiencies, the lead examiners will work with the issuer and participating jurisdictions to get them resolved. Whenever the issuer files a response to any deficiency, the lead examiners will reply within 5 business days.

  On the day the lead examiners clear the offering, all participating states will clear the offering.

- Adjustment of NASAA Statements of Policy for Regulation A filers. Merit states use various NASAA Statements of Policy (SOPs) to review offerings. In response to comments NASAA received from representatives of issuers, NASAA has made adjustments to these policies to better accommodate Regulation A filers. For example:
    - The SOP regarding promoter's equity investment requires promoters contribute a certain percentage of capital to the issuer. This helps align the interests of the promoters with those of the investors. Recognizing that promoters contributions to small business typically consist of "sweat equity" or other non-monetary contributions and that such contributions are difficult to value, this SOP will not be applied to Regulation A offerings.
    - The SOP regarding Promotional Shares requires that some discounted shares acquired by promoters with 5 years of the offering escrowed or subjected to a lock-in agreement. The maximum period for this lock-in or escrow is 5 years. These requirements will be modified for Regulation A filers to allow half of the escrowed

shares to be leased after one year, with the remainder to be released at the end of year two.

State regulators have particular strengths that uniquely qualify us to effectively oversee Regulation A+ offerings. As noted, we are geographically close and accessible to both investors and local businesses, putting us in a better position than the Commission to communicate with them about the offering to prevent abuse and improve the overall quality of the deal for investors and business alike. Our proximity to investors also puts us in the best position to deal aggressively with securities law violations when they do occur.

We cannot do our job – protect investors or help small businesses access capital and grow their companies – where Congress attempts to prohibit our review, as contemplated by the discussion draft proposal.

***Exclusion of Regulation A-acquired securities from the reporting thresholds of the Securities Exchange Act of 1934***

Under Section 4 of the discussion draft, holders of securities acquired pursuant to both 3(b)(1) and 3(b)(2) offerings would be excluded from the definition of "holders of record" for purposes of triggering the mandatory reporting requirements of the Securities Act of 1934. The JOBS Act increased the threshold for the 1934 Act ("'34 Act") reporting from 500 to 2,000 shareholders and excluded investors in crowdfunding offerings from this calculation. This proposal would expand the category of excluded investors by defining "holder of record" to exclude Regulation A and Regulation A Plus investors.

One of the fundamental tenets of securities law is that an investor is protected when the seller of securities is required to disclose sufficient information so that an investor can make an informed decision. Sufficient information also encourages a robust, transparent and legitimate secondary market. Section 12(g) of the '34 Act was enacted to ensure that as companies grew in size and complexity, so did their investor disclosures. Rather, companies could not avoid becoming public reporting companies once their shareholder base reached a certain threshold (currently, 2,000 shareholders, and over $10 million in total assets). Requiring companies of this size to become public reporting companies ensures that investors have sufficient information to make informed decisions.

Already the current "holder of record" definition creates confusion and allows many small and large private companies to avoid reporting requirements by creative shareholder recording methods. For instance, the current "holder of record" (or, rather holder of title) definition bears little correlation to actual shareholder qualifications as most shareholders rely on brokers, banks and other intermediaries to conduct transactions on their behalf. These "title" holders bear little resemblance to the actual "beneficial owner" of the shares.

Investors should be entitled to the same disclosures (current, quarterly and annual reports, audited financial statements, insider transaction notifications, etc.) from all companies meeting the shareholder threshold requirement regardless of the use of intermediaries. Excluding Regulation A, A Plus and crowdfunding investors from the calculation of "holder of record" will encourage companies to remain private and reduce the amount of information available to investors in the primary and secondary marketplace. This was not the intention of Section 12(g), and arguably not the intention of

Congress which has been actively seeking to increase the number of companies conducting IPOs and participating in the public marketplace.

Finally, unaccredited, retail investors that are participating in Regulation A or crowdfunding offerings are most directly impacted by a lack of sufficient information about small businesses and startup companies in which they are investing. These investors would benefit the most from reporting company disclosures—particularly when they are attempting to sell their shares in the secondary market. Not including these investors will also be difficult and time-consuming for issuers from a logistical standpoint as companies will need to track beneficial holders, title holders and shares held in a street name, stocks sold in the secondary market, etc. Expending resources on this exercise cannot be in the best interest of companies trying to raise capital and create jobs.

***Secondary Market Sales to Accredited Investors***

Section 5 of the proposal would add a new transactional exemption in Section 4 of the 1933 Act ("'33 Act") for secondary market sales by any person other than an issuer, underwriter, or dealer. Purchasers must be accredited investors and general solicitation would be permitted provided the seller took reasonable steps to verify that the seller meets the definition of an accredited investor. Securities acquired under this new exemption would be considered securities acquired in a transaction under section 4(a)(2) of the Securities Act and, therefore, like rule 506 offerings, preempted from state registration. In sum this exemption would allow an individual investor to resell securities to any accredited investor in a preempted securities transaction. While NASAA is sensitive to the desire for increased liquidity for holders of unlisted securities, we believe that investor protection may be significantly compromised by this proposal.

Exempt transactions are subject to the antifraud provisions of the Securities Act which generally make it unlawful to offer or sell a security without fully disclosing all material facts. With respect to nonpublic companies, we are concerned that it will be very difficult for a selling security holder to obtain and provide to a purchaser the information required to fulfill this requirement. Traditional sources of information such as 10-K and 10-Q reports would be unavailable. The disclosure document the selling security holder received when he/she acquired the security will likely be significantly out-of-date. The issuer may not have, or be willing to reveal, material information about the company to a purchaser that it is not familiar with.

## II. Comments on Discussion Draft Legislation entitled "The Equity Crowdfunding Improvement Act"

During the debate surrounding the JOBS Act, NASAA asked Congress to leave the regulation of small investments in small companies to the states because the federal government has neither the inclination nor the resources to regulate effectively in this area. In testimony during consideration of the Act, we stated:

> NASAA firmly believes that the states should be the primary regulator of small business capital formation, including crowdfunding offerings. Based on the small size of the offering, the small size of the issuer, and the relatively small investment amounts, it is clear that the states have a more direct interest in these offerings. The states are in a better position to communicate with both

> the issuer and the investor to ensure that this exemption is an effective means of small business capital formation. The states will be most familiar with the local economic factors that affect small business and have a strong interest in protecting the particular investors in these types of offerings. Further, requiring the SEC to regulate these small, localized securities offerings is not an effective use of the agency's limited resources.[12]

Before the JOBS Act was even introduced, three states allowed crowdfunding in intrastate offerings,[13] and during the debate on the Act, NASAA was working on a model exemption that would apply to multi-state offerings. The model rule envisioned a one-stop filing mechanism and the application of uniform review standards. Unfortunately, those efforts were halted when Congress enacted a federal exemption for crowdfunding that preempted state authority.

Ironically, many crowdfunding advocates that have grown frustrated with the pace of federal rulemaking and, in some cases, dissatisfied with the federal exemption itself, are again seeking state-level crowdfunding exemptions. Bills have been introduced in over 20 states—and have passed in 7 states—to allow intrastate offerings that involve equity crowdfunding.[14] A number of other states are considering this type of legislation. This underscores why Congress should let the states innovate and be creative in striking a reasonable balance between investor protection and capital formation for smaller offerings.

The JOBS Act was enacted into law on April 5, 2012. Title III allows issuers to raise no more than $1 million per year through the new crowdfunding exemption and limits individuals from investing no more than $2,000 or 5-10% of their annual income, whichever is greater, per year, based on applicable net worth and income thresholds.[15] While much of the new federal crowdfunding structure and compliance requirements were articulated by Congress in the JOBS Act itself, the SEC was given 270 days to promulgate rules to implement the new offering exemption. The SEC released their rule

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[12] Written Testimony of Jack E. Herstein, President of the North American Securities Administrators Association, Inc. and Assistant Director of the Nebraska Department of Banking & Finance, Bureau of Securities before the Senate Committee on Banking, Housing, and Urban Affairs at a hearing entitled "Spurring Job Growth Through Capital Formation While Protecting Investors." December 1, 2011.
http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=255a1e89-30b9-4036-9560-b4a0db5def80

[13] Two states – Kansas and Georgia – adopted exemptions before the JOBS Act was even introduced. See the "Invest Kansas Exemption," Kan. Admin. Reg. 81-5-21 (adopted Aug. 12, 2011) and the nearly identical "Invest Georgia Exemption," Ga. Rule 590-4-2-.08 (adopted Dec. 2012). Idaho adopted an exemption by order on January 20, 2012, which imposes similar conditions upon crowdfunding as the Kansas and Georgia regulation.

[14] As of May 1, 2014 the following states have passed equity crowdfunding bills into law: Alabama Act No. 2014-376 (bill SB 44) became law on April 8, 2014; Indiana Public Law 106 (bill SB 375) became law on March 25, 2014; Maine Chapter 452 (bill LD 1512) became law on March 2, 2014; Maryland HB 1243/SB 811 became law on March 13, 2014; Michigan Public Act 264 (bill HB 4996) became law on December 26, 2013; Washington Chapter 144 (bill HB 2023) became law on March 28, 2014; and Wisconsin Public Act 52 (bill AB 350) became law on November 7, 2013.

[15] The United States Securities and Exchange Commission has proposed further restricting the five percent (5%) and ten percent (10%) individual investor limitation to a $100,000 total cap in its crowdfunding rule proposal. See SEC Release Nos. 33-9470; 34-70741 (October 23, 2013), available at http://www.sec.gov/rules/proposed/2013/33-9470.pdf. The SEC proposed expanded the restriction in another sense, however, by allowing investors to utilize the higher of either net worth or income standards in applying the 5% and 10% limitations

proposal on October 23, 2013[16] and formal comments were due on February 3, 2014.[17] We would expect the final rules to be forthcoming.

The "Equity Crowdfunding Improvement Act of 2014," proposed by Representative McHenry (R-NC), repeals the existing crowdfunding framework and replaces it with a new version of Title III that is "[i]n response to comment letters received by the SEC and concerns with the underlying statute that may make crowdfunding difficult to implement."[18] While NASAA has strong concerns with a number of the provisions outlined in the new draft, we also recognize that there may be provisions in Title III that may limit its utility for certain issuers. Until the final rules are implemented and issuers are able to participate in crowdfunding, however, it is impossible to evaluate the impact Title III will have on capital formation, job creation and investors' willingness to invest through crowdfunding. We caution that a number of the changes proposed by the draft bill would decrease protections that were central provision Congress included to minimize severe investor risk, and that are vital to encouraging their participation and confidence in crowdfunding.

The expressed rationale for Title III of the JOBS Act was to provide small, startup businesses access to capital from "the crowd" that may otherwise not be available. However, because low net worth and less sophisticated investors would be able to participate in these offerings, and because of the high risk nature of investing in start-up ventures, Congress determined certain investor protections crucial forsuccess.[19] We are concerned that the higher individual and aggregate offering limits, and the ability of an issuer to conduct parallel offerings above the aggregate threshold set forth in the bill, would critically undermine the potential success of equity-based crowdfunding. In fact, Congress viewed $1 million as a sufficient boost for small businesses using crowdfunding to get their start. As Senator Jeff Merkley (D-OR), the author of the Senate amendment containing the relevant language, explained: "[T]he amendment allows existing small businesses and startup companies to raise up to $1 million per year. That is a substantial amount for a small business."[20] Senator Merkley also stated, "Without

[16] SEC Release Nos. 33-9470; 34-70741 (October 23, 2013), available at http://www.sec.gov/rules/proposed/2013/33-9470.pdf

[17] *See* NASAA Comments in Response to [SEC] Release Nos. 33-9470 and 34-70741 (File No. S7-09-13), "Crowdfunding"; ***available at***: http://www.sec.gov/comments/s7-09-13/s70913-286.pdf.

[18] *See* Memorandum From House Financial Services Majority Staff To Members of the Committee on Financial Services, Subject: *May 1, 2014, Subcommittee on Capital Markets and Government Sponsored Enterprises Hearing Entitled "Legislative Proposals to Enhance Capital Formation for Small and Emerging Growth Companies, Part II"* (April 28, 2014). *Available at*: http://financialservices.house.gov/uploadedfiles/050114_cm_memo.pdf.

[19] The SEC's Investor Advisory Committee ("IAC") recently issued a recommendation regarding the SEC's crowdfunding regulations. The proposal notes that implementing crowdfunding presents "a significant regulatory challenge" to balance the cost of compliance with the risk of investor loss. It makes the following preliminary observation: "[O]ne of the benefits of the current financing model is that either a skilled investor, a close-knit family or community, or a third party institution such as a bank providing debt financing, is reviewing, investing and then monitoring the investment. In contrast, crowdfunding enables a broad and diverse investing community where there may or may not be a person or entity that has the means or the interest to engage in such pre-investment or post-investment monitoring." The IAC outlines several areas where the SEC can "strengthen" its proposed rules "to better ensure that investors understand the risks of crowdfunding and avoid unaffordable financial losses." *See* "Recommendation of the Investor as Purchaser Subcommittee: Crowdfunding Regulations" (April 10, 2014), *available at* http://www.sec.gov/spotlight/investor-advisory-committee-2012/crowdfunding-recommendation.pdf.

[20] 158 CONG. REC. S1829 (daily ed. Mar. 20, 2012).

aggregate caps, someone could in theory max out a per-company investment in a single company and then repeat that bet ten, a hundred, or a thousand times, perhaps unintentionally wiping out their entire savings."[21]

A loss of up to $5,000 or 10% of annual income or net worth, as proposed in the bill, could be a crippling loss for many investors. A 2013 survey indicated that 57 percent of American households had less than $25,000 in total savings and investments.[22] The typical retail investor, unlike the traditional small business financier, also does not have the ability to conduct a reasonable investigation of a start-up or development-stage entity. In fact, small businesses start-ups tend to have little or no operational history or experience. The company's business model, intellectual property, technology and other assets are untested, and the company may require additional rounds of financing, thus diluting early investors' shares. In fact, failed businesses are often considered a badge of honor for entrepreneurs.[23]

We are also concerned about a number of other provisions in the bill, including (i) reducing required financial disclosures that an issuer must provide to investors; (ii) reducing important disclosure requirements for both issuers and intermediaries; (iii) removing any disclosure requirements for issuers that are selling shares directly to accredited investors; (iv) removing any civil liability provisions against an issuer for rescission for material misrepresentations or omissions; (v) preempting states from regulating crowdfunding offerings, reducing the amount of information required to be disclosed to states and removing any requirement that the SEC consult with the states during rulemaking[24]; (vi) removing the mandatory securities enforcement regulatory check on control persons and other insiders of the issuer; and (vii) reducing the breadth of issuer and intermediary disqualifications.

We would be happy to work with the Subcommittee in addressing any areas that may make crowdfunding impractical after the SEC issues its final rules. Many state bills contain some of the changes addressed in this draft bill, including allowing an intermediary to avoid federal broker-dealer registration so long as they do not (1) offer investment advice or recommendations; (2) explicitly solicit purchases, sales, or offers to buy particular securities offered or displayed on its website or portal; (3) directly compensate employees, agents, or other persons for the direct sale of securities displayed or referenced on its website or portal; or (4) manage, possess, or otherwise handle investor funds or securities. Moreover, we note that the draft bill only requires an intermediary when issuers sell to unaccredited investors; thus, issuer-based transactions are allowed. Some state bills also contemplate issuer-based transactions. While NASAA has not taken a position on this aspect of intrastate

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[21] 158 CONG. REC. S5476 (July 26, 2012).

[22] According to the Employee Benefit Research Institute's 2013 Retirement Confidence Survey, 57% of workers in the U.S. have less than $25,000 in total savings and investments; *available at* http://www.ebri.org/pdf/surveys/rcs/2013/Final-FS.RCS-13.FS_3.Saving.FINAL.pdf.

[23] Statistics show that unfortunately, roughly 50 percent of small businesses fail within the first five years. U.S. Small Business Administration. http://indus.sba.gov/smallbusinessplanner/plan/getready/SERV_SBPLANNER_ISENTFORU.html Statistics also show that from 1994-2005, on average, only 48.8% of new business establishments survived beyond five years. U.S. Bureau of Labor Statistics. *Available at*: http://www.bls.gov/bdm/entrepreneurship/bdm_chart3.htm.

[24] States, as the primary regulator of small business offerings, have a direct interest in the SEC's rulemaking and implementation of the JOBS Act. Moreover, as the undisputed leaders in investigating and enforcing securities violations and fraud, we believe it is essential that the SEC and state regulators work together in crafting rulemaking.

crowdfunding, our longstanding position is that for crowdfunding to be successful, less sophisticated and less experienced investors must be adequately protected.

In conclusion, we recognize the need for small businesses to access capital in innovative ways that reflect modern realities; however, we urge this Subcommittee to analyze crowdfunding as a tool for capital formation after the legalization of crowdfunding. Finally, we ask that the Subcommittee consider the important role that states play in helping small, local businesses succeed and grow, and the success that states have had in implementing intrastate crowdfunding alternatives. If Congress determines to rewrite the federal crowdfunding rules, states should be an important part of the process and allowed to review and regulate these small offerings.

## III. Comments on Discussion Draft of legislation seeking to revise the SEC's existing and proposed amendments to Regulation D, Form D and Rule 156

NASAA has been asked to comment on the unnumbered discussion draft that states its purpose as "to direct the Securities and Exchange Commission to revise its proposed amendments to Regulation D, Form D, and Rule 156, as contained in release number 33-9416," issued on July 10, 2013.[25] The nature of the revisions specified by the draft reveal it as an assault on the authority of the SEC to provide basic, reasonable investor protection. Specifically, the legislation's primary purpose appears to be to eviscerate the few investor protection components the SEC has either adopted or proposed adopting in connection with the JOBS Act requirement to lift the ban on general solicitation for Regulation D Rule 506 offerings.

State securities regulators, pursuant to their antifraud authority, are the primary regulators of offerings conducted under Regulation D, Rule 506, and we are deeply concerned about the negative impact these recently implemented changes will have on investors in our states. In 2012, for instance, state regulators took 130 enforcement actions related specifically to Rule 506 offerings. Moreover, in 2012 the states pursued nearly 200 investigations of Rule 506 offerings likely leading to more enforcement actions reported for 2013.[26] Regulation D Rule 506 offerings were the violation most reported by the states in 2013. It is the fourth consecutive year that has topped NASAA's list of investor traps.

State securities regulators strongly oppose the policies contemplated by the draft, as indeed we would be opposed to any actions by Congress that might diminish the ability of the SEC to undertake prudent steps to attenuate the significant potential risks to investors that has arisen due to the lifting of the ban on general solicitation pursuit to Section 201 of the JOBS Act.

### *Discussion Draft Section I. – Prohibition on the Exercise of SEC Authority to Require Advance Filing of "Form D" for Rule 506 Offerings Relying on General Solicitation*

In order to conduct actions and investigations of fraudulent Rule 506 offerings, state regulators routinely review Form D filings (i.e., a notice filing to the SEC after the first sale of securities pursuant to

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[25] It is notable that the scope of the draft exceeds Release Number 33-9416, as Section (3) of the draft would constitute revisions of existing Regulation 506(c), as amended on July 23, 2013 and effective September 23, 2014.

[26] Many states do not maintain statistics for the various types of offerings that result in enforcement actions. As a result, the number of state enforcement actions and investigations related to Rule 506 offerings are likely to be significantly higher than the reported statistics.

the Rule 506 exemption, which informs both the SEC and state regulators that a company is conducting a "private" offering in reliance on the exemption). Unfortunately, the SEC does not conduct a substantive review of these offerings, or their corresponding Form D filings – however, for state regulators, the information captured by the Form D is often the first and only indication that an offering being advertised and sold to investors in their state is being conducted under the Rule 506(c) exemption.[27]

Prior to removal of the long-standing ban on general solicitation and advertising, state securities investigators could be assured that any securities offering relying on general solicitation was registered with the SEC. State securities regulators commonly encourage investors in their states to "investigate before they invest." Typically this results in communications by state regulators with investors—notably, many local "mom and pop" investors—who are seeking information about issuers and potential investments.

With the removal of the general solicitation and advertising prohibition, state investigators no longer have any way to determine whether the issuer is advertising an unregistered, and non-exempt, offering to the general public or engaging in a compliant Rule 506 offering.

To address this major impediment to effective state oversight of Rule 506 offerings, the SEC, on July 10, 2013, proposed a two-part Form D filing requirement for issuers performing a securities offering and using general solicitation. Under the proposed rules, issuers would be required (1) to file a Form D no later than 15 days in advance of the first use of general solicitation in a Rule 506(c) offering, and (2) to file a closing Form D amendment within 30 days after the termination of a Rule 506 offering. The SEC's decision to propose Form D pre-filing requirements for Rule 506 offerings being advertised to the general public was undertaken both in order to improve the SEC's understanding of the Rule 506 market, and in direct response to pleas from state securities regulators.[28]

This single, modest adjustment to the Form D filing requirements for Rule 506 offerings, which are advertised to the general public, would go a very long way in addressing the practical realities that state enforcement personnel now confront. Indeed, adoption of a prefiling requirement could ensure that state securities regulators, and the SEC, are able to determine an issuer's intent to rely on general solicitation and advertising; enable state regulators to respond to questions from investors in their states about publicly advertised offerings; and permit local investors – who can also access Form D filings – to access basic background information about "legitimate" offerings before they invest.

As NASAA explained in a comment letter filed with the Commission, in connection with its rulemaking to implement Section 201 of the JOBS Act:

> [I]t is essential for state regulators and prospective investors to have access to the information disclosed in Form D at or before the time an issuer begins to advertise to

[27] As described in SEC Inspector General Report No. 459, "Regulation D Exemption Process" (March 31, 2009), the Commission conducts no substantive review of Form D filings to determine whether an issuer actually complies with Rule 506. See http://www.sec-oig.gov/Reports/AuditsInspections/2009/459.pdf

[28] The SEC's Proposing Release notes that the prefiling requirement is intended, in part, to enhance the SEC's understanding of the Rule 506 market by improving compliance with Form D filing requirements. See, *SEC Release 33-9416, 34-69960, IC-30595, Amendments to Regulation D, Form D and Rule 156 (July 10, 2013), 78 Fed. Reg. 44806 (July 24, 2013). http://www.gpo.gov/fdsys/pkg/FR-2013-07-24/html/2013-16884.htm*

> the general public. With the Commission's recent lifting of the ban on general solicitation, we anticipate a substantial increase in the number of investors who will want this type of information. However, without a requirement that the Form D be filed prior to the use of general solicitation, there is no way for state securities regulators to respond to these basic questions. An investor that contacts a state securities regulator to ask about an offering is simply being diligent, and state regulators should have the information necessary to respond to such inquiries.
>
> In addition, the lack of a pre-solicitation filing makes it impossible for state enforcement personnel to easily determine whether an offering is being conducted in accordance with the securities laws.
>
> We do not believe a fifteen day advance filing requirement is unduly burdensome to an issuer who wishes to seek investments from the general public…[t]he critical issue is that the Form D should be publicly accessible before an issuer begins to publicly solicit investors.[29]

Unfortunately, Section (1) of the draft would prevent the SEC from effectuating this sensible and badly needed reform by short-circuiting the SEC's rulemaking in this critical area, and would eliminate the least burdensome and most effective step the Commission might take to improve oversight of Rule 506 offerings in the post-JOBS Act era.

***Discussion Draft Section II. – Prohibition on the Exercise of SEC Authority to Improve Compliance with Form D Filing Requirements***

For far too long, the Commission has failed to address a glaring problem in Rule 506 offerings. Currently, Rule 503 of Regulation D imposes a Form D filing requirement of no later than 15 calendar days after the first sale of securities in the offering, but issuers failing to meet this requirement do not face meaningful consequences under Regulation D.[30] As reported by the SEC Inspector General in 2009, "there are simply no tangible consequences when a company fails to file a Form D."

The voluntary nature of Form D has significant repercussions for state regulators. States are preempted from requiring registration of securities that are sold in compliance with Rule 506, and, as already explained, state regulators routinely review Form D filings to ensure that the offerings actually qualify for an exemption under Rule 506 and to look for "red flags" that may indicate a fraudulent offering. The absence of a Form D filing complicates our efforts to protect the investing public. In addition, a promoter who has no intention of complying with Rule 506 may attempt to assert it as a defense to a state-level enforcement action by filing a Form D long after the fact.

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[29] NASAA Comments in Response to Release Nos. 33-9416, 34-69960, IC- 30595 (File No. S7-06-13), "Amendments to Regulation D, Form D and Rule 156 under the Securities Act." September 27, 2013. http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Comment-Letter-re-Form-D.pdf

[30] Rule 507 removes the availability of Regulation D to an issuer in circumstances that would be unlikely to occur absent litigation:

> No exemption under §230.505, §230.505 or §230.506 shall be available for an issuer if such issuer, any of its predecessors or affiliates have been subject to any order, judgment, or decree of any court of competent jurisdiction temporarily, preliminary or permanently enjoining such person for failure to comply with §230.503.

To remedy the deficiencies arising from the "voluntary" nature of the filing requirement currently prescribed by Rule 503, the SEC's Proposing Release on July 10, 2013 proposes to amend Rule 507 to disqualify an issuer from relying on Rule 506 for one year for future offerings if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the last five years, with all the Form D filing requirements in a Rule 506 offering.

Section (2) of the discussion draft would prevent the SEC from taking action to adopt this vital component of its proposal, which the Proposing Release notes is necessary to improve compliance with Form D filing requirements. Just as in the case of the prohibition contemplated under Section (1) of the draft, Section 2 would, without any cogent or valid policy basis, serve to deprive investors and regulators of the ability to reliably access basic information they require to understand and make informed decisions regarding the Rule 506 marketplace.

***Discussion Draft Section III. – Elimination of Accredited Investor Verification Provisions Mandated by Section 201 of the JOBS Act and Implemented Effective Sept. 23, 2013.***

Section 201(a)(1) of the JOBS Act mandated that the SEC's amendments to Rule 506 require issuers using general solicitation in Rule 506 offerings ''to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission." When the SEC amended Rule 506 in 2013 to permit an issuer to engage in general solicitation or general advertising in offering and selling securities pursuant to Rule 506, this amendment included the provision that all purchasers of the securities be accredited investors and that the issuer take reasonable steps to verify that such purchasers are accredited investors. In its Regulation D Amendments Adopting Release,[31] the SEC emphasized that the requirement that the issuer take reasonable steps to verify the accredited investor status of purchasers be separate from and independent of the requirement that sales be limited to accredited investors, and must be satisfied even if all purchasers happen to be accredited investors, noting that "this [separate and apart requirement] will avoid diminishing the incentive for issuers to undertake the reasonable verification steps envisioned by the statute [the JOBS Act]."[32]

The amendment to Rule 506 also included a non-exclusive list of methods that issuers may use to satisfy the verification requirement for purchasers who are natural persons, which the SEC noted would maintain the flexibility of the verification standard while providing additional clarity and certainty that this requirement has been satisfied if one of the specified methods is used. The SEC also noted that availability of the Regulation D Rule 506(c) exemption for an issuer would remain in circumstances where a non-accredited investor may invest in the offering, as long as an issuer has taken reasonable steps to verify that a purchaser is an accredited investor. Therefore, availability of the exemption would not be jeopardized by a sale to an unaccredited investor, provided the issuer maintains reasonable controls and compliance.[33]

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[31] SEC Release 33-9415, 34-69959, IA-3624, Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings (July 10, 2013), 78 Fed. Reg. 44771 (July 24, 2013) ("Regulation D Amendments Adopting Release").

[32] <u>See</u> Footnote 101 at 78 Fed. Reg. 44778.

[33] "...it is possible that a person nevertheless could circumvent those [verification] measures. If a person who does not meet the criteria for any category of accredited investor purchases securities in a Rule 506(c) offering, we believe that the issuer will not lose the ability to rely on Rule 506(c) for that offering, so long as the issuer took

Once again, notwithstanding broad and bipartisan consensus that general solicitation under Rule 506 offerings should be limited to non-accredited investors, Section (3) of the discussion draft proposes to prohibit the SEC from acting consistent with the interests of investors – in this case, by barring the Commission from adopting rules requiring issuers to verify the accredited status of investors to whom they sell securities under the exemption. Section (3) would effectively eliminate completely the investor protection provisions included in the JOBS Act to ensure the retention of investor protections in the lifting of the ban of general solicitation for Rule 506 offerings.[34]

NASAA strongly opposes Section 3 of the draft on the grounds that it would substantially increase the risks associated with allowing general solicitation of Rule 506 offerings, and the likelihood that it would increase the likelihood that securities offered under Rule 506 would be sold to unsophisticated "mom and pop" investors.

NASAA further objects to Section (3) as it appears to be contrary to the bipartisan commitment reached in Congress, and articulated publically, by members of the Financial Services Committee, without which Title II of the JOBS Act may never have been enacted. Indeed, Section (3) of the draft would effectively prevent implementation of critical amendments offered by Ranking Member Maxine Waters (D-CA) during the Subcommittee markup of the JOBS Act, in October 2011.[35]

***Discussion Draft Section IV. – Prohibition on Exercise of SEC Authority to Provide Guidance to Private Funds in Developing Sales Literature that is Neither Fraudulent nor Misleading.***

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reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor at the time of sale." See, 78 Fed. Reg. 44783.

[34] Section (3) of the draft provides: "(3) An issuer's obligation under section 201(a) of the JOBS Act and under Rule 506(c) of Regulation D (17 C.F.R. 230.506(c)) to take reasonable steps to verify that purchasers of the securities are accredited investors shall not be a condition to the availability of the exemption under such Rule. The Commission shall not condition the availability of any exemption for an issuer under Rule 506 of Regulation D on the steps taken by issuers to verify that purchasers of the securities are accredited investors, as required under section 201(a) of the JOBS Act and under Rule 506(c) of Regulation D 2 (17 C.F.R. 230.506(c))."

[35] During the Subcommittee's consideration of Title II of the JOBS Act, then-Ranking Democratic Member, Rep. Maxine Waters (D-CA), appeared to condition support for the legislation on SEC rulemaking to ensure that such securities would only be sold to accredited investors. **Section 3 of the discussion draft would prohibit precisely such a rulemaking.** *See, House Financial Services Committee markup of H.R. 2940, the Access to Capital for Job Creators Act. October 4, 2011. Amdt. #1, offered by Ms. Waters. (H. Rept. 112-263). http://financialservices.house.gov/uploadedfiles/100511hr2940watersam.pdf*.

> **Ranking Member Waters**: *"I feel that I can only tentatively support [this] bill, which would remove the prohibition on general solicitation or general offers of securities made under rule 506 of Regulation D, if those securities were only sold to accredited investors. My amendment would require the SEC when issuing a rule to…include a provision mandating that issuers take reasonable steps to verify investor status as an accredited investor."*
> **Chairman Garrett (R-NJ)**: *"I know that [Ms. Waters] just referred to the SEC, [which] will then be required to promulgate rules…I believe that it is a good amendment. I also encourage support of the amendment."*

*See, House Financial Services Committee markup of H.R. 2940, the Access to Capital for Job Creators Act. October 4, 2011. Amdt. #1, offered by Ms. Waters. (H. Rept. 112-263). http://financialservices.house.gov/uploadedfiles/100511hr2940watersam.pdf*

Finally, the discussion draft includes a provision that appears intended to prevent the SEC from providing guidance on the types of information in Regulation D, Rule 506 general solicitations that could be misleading. The SEC has proposed that Rule 156, which provides guidance on the types of information in investment company sales literature that could be misleading, apply to marketing materials for Rule 506 securities. The utility of providing guidance to issuers regarding the advertising of Rule 506 offerings is self-evident—not only from the standpoint of investors in Rule 506 offerings, but also issuers.

Once again, as elsewhere, Section (4) of the discussion draft appears to eschew the possibility of an optimal or balanced approach to the lifting of the ban on general solicitation in favor of policies that jeopardize basic protections for investors. In this case, state securities administrators consider that the most likely consequence of handcuffing the SEC in this manner would be the undermining of protections for investors and the viability of the marketplace for Rule 506 offerings sold through general solicitation. NASAA strongly urges Congress to reject such a course of action.

## NASAA Comments on Additional Legislative Proposals to Enhance Capital Formation for Small and Emerging Growth Companies

In addition to the three discussion drafts that comprise the immediate focus of today's hearing, state securities regulators have been asked by a number of members of the Subcommittee to comment on other, related bills, pending before the Subcommittee that were the focus of a hearing before the Subcommittee on April 9, 2014, and which the Financial Services Committee may be considering in the near future.

### H.R. 2629, "The Fostering Innovation Act of 2014"

This bill reduces the number of companies that would qualify as accelerated filers. Currently, companies with a public float over $75 million qualify as accelerated filers. Were this bill to be enacted, firms with public floats of less than $250 million or revenue of less than $100 million would no longer qualify as accelerated filers. Interestingly, the addition of the revenue exception means that a 50-year-old, stale company might still avoid being an accelerated filer. The JOBS Act exempted "emerging growth companies" (EGCs) from the audit obligation for a maximum of five years; this bill would do the same for older companies that did not qualify under that legislation, but the exemption would continue indefinitely.

The principal requirements that non-accelerated filers avoid are accelerated filing requirements, e.g. having a full 90 days to file the annual report rather than the 75 days available to an accelerated filer, and certain other audit-related requirements, i.e. that management must include in the annual report a statement as to the adequacy of the company's internal controls and that the company's outside accountants must file an attestation regarding the management's assurance.[36]

Neither slower filing requirements, nor the lack of an outside auditor review of company financial controls, contribute to strengthen investor protection. Investors will be adversely impacted in

[36] Section 404(b) of the Sarbanes-Oxley Act, which requires accelerated filers to obtain an annual audit of their internal controls.

that they will receive information about companies somewhat slower (i.e. the annual report may be filed up to 15 days later) and thus, will not have the assurances and/or improved internal controls that might result from a required annual internal controls evaluation by an outside auditor.

On the other hand, the degree to which this legislation may negatively impact investors is likely to be mitigated by a number of factors: (1) annual and quarterly reports are still required, albeit slightly less quickly; (2) non-accelerated filers are still required to comply with the SEC's rigorous reporting requirements, including audited financial statements; (3) state authority will remain in place; and (4) the legislation's "internal-controls" requirement, while required under federal law, is not required by most, if not all, states unless it is also required by federal law.

Ultimately, the primary impact of H.R. 2629 is likely to be that it will save companies money by reducing compliance costs on businesses. A 2009 SEC study indicated that the median total compliance cost for non-accelerated filers was $439,000, most of which were auditors' fees.[37] For this reason, Congress exempted non-accelerated filers from the annual independent auditor evaluation; H.R. 2629 further expands the universe of companies that benefit from this cost savings.

## H.R. 4200, the "SBIC Advisers Relief Act of 2014"

H.R. 4200 would amend the Investment Advisers Act of 1940 to expand the registration exemption under §203(l) (which exempts venture capital fund advisers) to cover persons who are advisers to both venture capital funds and small business investment companies ("SBICs"), and would exclude SBIC assets from the SEC registration threshold calculation. H.R. 4200 would also exclude SBIC assets from the SEC registration threshold calculation and would preempt state regulation of SBIC fund advisers.

State securities regulators appreciate that, on its face, H.R. 4200 does not appear to directly threaten retail investors. However, we are concerned that the preemption of state law would exempt advisers of SBICs from all state and federal registration focused on investor protection. The removal of all forms of state and federal oversight of persons acting as the adviser of SBIC funds, under this bill, may have unforeseen downstream effects on the securities markets which will negatively impact retail investors. NASAA recommends that Section four of H.R. 4200 be amended to permit states the option of requiring the registration of any person acting solely as an adviser to an SBIC.

SBICs are exempt from the Dodd-Frank Consumer Protection and Wall Street Reform Act's "Volcker Rule," which prohibits banking entities from engaging in most forms of proprietary trading, and prohibits them from acquiring an ownership interest of more than 3% of any private equity or hedge fund. Because SBICs are exempt from the Volcker Rule, banking institutions can acquire ownership in an SBIC in excess of 3% of an SBIC's total equity. As a result, banking institutions and fund managers may seek to form, manage, and invest in SBICs as an alternative to bank-sponsored private equity and hedge funds, which were widely used before the Dodd-Frank Act was enacted.[38] Although banks and fund

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[37] Office of Economic Analysis, U.S. Securities and Exchange Commission, *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements*. (September 2009).

[38] Bank-sponsored funds were attractive to investors because such funds had the imprimatur of the investment bank's substantial investment, and because the investment bank could call upon a vast network of advisers and investment opportunities, thus increasing the funds' likelihood of success. The Columbia Business Law Review.

managers that elect to form SBICs will still need to satisfy various requirements under the Small Business Act, given the uncertainty of precisely how SBICs may be utilized going forward, it is premature to conclude that Congress should remove all means for subjecting advisers to such funds from any prospect of direct oversight.[39]

### Discussion Draft entitled "The Disclosure Modernization and Simplification Act of 2014"

This draft legislation proposes that the SEC permit issuers to submit a summary page as part of a Form 10-K filing, in order to make annual disclosures easier to understand for current and prospective investors. It would also direct the SEC to reform Regulation S-K and tailor its disclosure rules as they apply to smaller issuers and EGCs.

In his April 9, 2014 testimony to the Subcommittee, Professor John C. Coffee, Jr. stated that he had no "conceptual objections" to such a cross-reference sheet, primarily because he believes cross-referencing is currently in place and thus, legislation is not unnecessary.[40] In reviewing the SEC website, it does appear that Form 10-K cross-referencing by hyperlink is already widely used on the Electronic Data-Gathering, Analysis, and Retrieval ("EDGAR") system.

However, NASAA does have some concerns about Section (3) of the discussion draft, which directs the SEC to revise Regulation S-K to "further scale or eliminate" disclosure requirements that are perceived as burdensome to smaller issuers and EGS and "duplicative, overlapping, outdated, or unnecessary" as to all issuers. Similarly, Section 4(a)(3) of the discussion draft proposes that the SEC engage in studies that "explore methods for discouraging repetition and the disclosure of immaterial information." This language suggests that the bill's proponents consider that some of the information that is currently required to be reported on Form 10-K is immaterial, and that a study may serve as a precursor to eliminating some categories of "boilerplate" information that are currently reported on Form 10-K.

In fairness, there has been bipartisan dialogue and scholarly debate about whether a one-size-fits-all reporting requirement makes sense for all issuers, especially those reporting requirements that may be cost-prohibitive or inapplicable for issuers of smaller size (i.e. some environmental impact disclosures).

Thus, state securities regulators do not oppose the "Disclosure Modernization and Simplification Act of 2014". We do, however, believe that it could be improved by adding language to Section (3) that is consistent with Section (4)'s requirement that any changes to Regulation S-K disclosures are made

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Frydman, David. Sidestepping the Volcker Rule: The Emergence of SBICs as a Viable Replacement for Bank-Sponsored Investment Funds. November 17th, 2012. http://cblr.columbia.edu/archives/12417

[39] While it is not yet clear precisely how adoption of the Volker Rule will impact the activities of SBIC, the financial and academic literature suggest there is at least a potential for it to have a significant impact, and thus, such absence of such clarity is in-and-of itself a basis for caution in considering deregulation of this area. See: "SBIC Revival: Why Interest From Banks Is Way Up, As The Volcker Rule Looms." By Kite, Shane. *American Banker*. April 28, 2014. http://www.americanbanker.com/magazine/124_04/volcker-rule-brings-sbics-back-in-vogue-1066822-1.html

[40] Statement of Professor John C. Coffee, Jr. at p. 10, "Legislative Proposals to Enhance Capital Formation for Small and Emerging Growth Companies" (April 9, 2014). http://financialservices.house.gov/uploadedfiles/hhrg-113-ba16-wstate-jcoffee-20140409.pdf

17 C.F.R. 229.10 et seq.

"while still providing all necessary material information." Such a provision would ensure that there is a balancing between reducing costs and burdens on smaller issuers, while maintaining transparency for investors.

## Discussion Draft legislation entitled "The Small Company Freedom to Grow Act of 2014"

The "Small Company Freedom to Grow Act of 2014" would expand the use of Form S-1 to allow for incorporation by reference; allow for the expanded use of Form S-3; and most significantly, instruct the SEC to submit a report to Congress recommending an amendment to Section 18 of the Securities Act of 1933 that would make securities issued by smaller reporting companies and emerging growth companies <u>not listed</u> on a national securities exchange covered securities.

State securities administrators are deeply concerned about this discussion draft, and NASAA would be strongly opposed to the legislation if it were introduced in its present form.

As a general matter, state securities regulators do not support Congressional preemption of state authority to protect investors. However, while NASAA opposes unwarranted federal preemption in all forms, we recognize that there are valid and legitimate rationales for policies that preempt state laws in connection with listed securities. Specifically, in the case of listed securities, the registration statement is reviewed by the SEC; the exchange typically has stringent listing standards and active market monitoring; and, especially in the case of a large listed security, there is generally ample information about the company accessible to retail investors, and such information is frequently filtered through analysts that follow the stock. In short, there are a number of regulatory eyes watching the issuers combined with ample disclosure, which collectively provides investors with some security regarding the legitimacy of the issuer.

By contrast, in the case of non-listed companies, these safeguards simply are not present. Even if these companies file registration statements, non-listed issuers are not subjected to any listing standards or scrutiny from the listing exchange, nor are they typically monitored by investment analysts.

There is absolutely no cogent reason to preempt state regulators for companies that can't achieve a listing. Quite to the contrary; if an issuer can't satisfy the criteria for a listing on even one of the smaller national exchanges, the states' role in performing oversight of their offerings is essential.

The policies embodied in the proffered draft legislation would reduce disclosure, and provide few if any prospective benefits to investors or small businesses seeking access to capital, while raising a host of concerns about the effective oversight of small and unlisted securities offerings. State securities regulators strongly urge Congress to reject this ill-advised legislation.

## Discussion Draft legislation to require the SEC to increase the threshold amount for requiring issuers to provide certain disclosures relating to compensatory benefit plans.

Rule 701, adopted pursuant to Section 3(b) of the Securities Act of 1933, provides an exemption from the registration requirements of the Securities Act for securities offered to employees or consultants pursuant to a written compensatory employee benefit plan or a written contract by an issuer that is a non-reporting company (a non-public issuer) under the Exchange Act.[41] The purpose of Rule 701 is to facilitate the use of securities for compensation to employees for private companies, including start-ups. Rule 701 is not available for other purposes, such as raising capital. Securities issued pursuant to plans or schemes designed to evade the registration requirements of the Securities Act, although in technical compliance with Rule 701, are required to be registered.

Under current Rule 701, an issuer can offer any amount of securities. The aggregate sales price or amount sold in any consecutive 12-month period is limited to the greatest of either $1 million, 15 percent of the company's assets, or 15 percent of the outstanding securities of the class. The issuer must always provide a copy of the plan or contract to the investor. Additionally, if the amount of securities sold during any consecutive 12-month period exceeds $5 million, the issuer must make certain additional disclosures to the employees, including: 1) a copy of the summary plan description required by the Employee Retirement Income Security Act ("ERISA") or, if the plan is not subject to ERISA, a summary of the material terms of the plan, 2) information concerning risks associated with the securities sold, and 3) unaudited financial statements required by Regulation A (unaudited financials are acceptable).

The Rule 701 exemption is available only to the securities offered or sold by the issuer, and the employee must find another exemption for their resale. Such securities are deemed restricted securities as defined by Rule 144 of the Securities Act of 1933. Therefore, the securities can be resold pursuant to a registration statement, in a private transaction (Section 4(1½) exemption), or pursuant to Rule 144. Section 501 of the JOBS Act raised the threshold for mandatory registration under Section 12(g) of the Exchange Act from 500 to 2,000 shareholders of record, and shareholders "of record" now exclude persons who receive securities pursuant to an employee compensation plan.

The discussion draft legislation proffered by Rep. Hultgren (R-IL) directs the SEC to amend Rule 701 to increase the amount of securities that may be sold from $5 million to $20 million in a 12-month period before the additional disclosures must be made. It is important to note that Rule 701 relates only to the registration requirements of the Securities Act, and issuers have an obligation to provide investors with disclosures adequate to satisfy the anti-fraud provisions of the federal securities laws.

Securities sold pursuant to the Rule 701 exemption are not sold to retail investors, and thus NASAA does not consider the policy changes contemplated by the draft as likely to directly threaten or materially impact "mom and pop" investors. Nevertheless, on balance, NASAA does not believe it would be prudent for Congress to mandate raising the disclosure for the Rule 701 threshold in an effort to spur capital formation. In the first instance, the purpose of Rule 701 is to compensate employees, not to raise capital.[42] In addition, the SEC has expressed concerns that raising the threshold for additional disclosures to $20 million would create investor protection concerns. Indeed, when the SEC, in 1999,

[41] The Rule 701 exemption is not available to companies which are investment companies or reporting companies under the Exchange Act.

[42] The SEC and the text of Rule 701 are clear on the purpose of the rule. The SEC has stated, "[Rule 701] is specifically designed not to raise capital," while the text of Rule 701 states, "The purpose of [Rule 701] is to provide an exemption from the registration requirements of the Act for securities issued in compensatory circumstances. [Rule 701] is not available for plans or schemes to circumvent this purpose, such as to raise capital." See 17 C.F.R. § 230.701 (2014).

considered the implications of amending Rule 701 to remove the $5 million aggregate offering price ceiling, the staff expressed concerns regarding investor protection, stating:

> We would have investor protection concerns if we removed the $5 million ceiling without imposing specific disclosure requirements.... In contrast, we believe that disclosure requirements are not needed for offerings below the $5 million threshold at this time. We have not witnessed abuse below this threshold, and therefore the burden of preparing and disseminating the new disclosure does not justify the potential benefits to employee-investors.[43]
>
> In view of the substantial amounts of securities that may now be issued under Rule 701, we believe that a minimal level of disclosure consisting of risk factors and Regulation A unaudited financial statements is essential to meet even the lower level of information needed to inform compensatory-type investors such as employees and consultants.[44]

Further, because companies already have prepared the type of disclosure required by Rule 701, the disclosure requirements should not create an additional burden. Indeed, as the SEC observed:

> [A] number of commenters told us that this information is commonly maintained by this class of issuer (generally not small entities) in order to satisfy requirements for securities issuance exemptions (such as for private placements), loans and other purposes such as regulatory and internal ones, [and] the amendments will not increase reporting, recordkeeping or compliance burdens, and may reduce those burdens for some companies.[45]

Moreover, allowing small startups to compensate key, early-stage employees with stock is sensible because these employees likely have access to the same kind of information that the Act would make available in the form of a registration statement. However, if companies are allowed to issue up to $20 million in a 12-month period without making any disclosures to investing employees, it is foreseeable that a company could become relatively large without making any disclosures. The larger a company is, the less likely it is that employees will have access to the type of information necessary to make an informed investment decision, especially since Rule 701 does not limit which employees may invest. Thus, the very basic disclosures provided at $5 million are necessary to protect investing employees.

Finally, raising the disclosure limit to $20 million under Rule 701 may incentivize companies to substitute stock for traditional employee compensation. This increases the risk to employee investors and, in turn, increases the need for additional disclosure.

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[43] Rule 701—Exempt Offerings Pursuant to Compensatory Arrangements, 64 FR 11095-01 (Mar. 8, 1999).
[44] *Id.*
[45] *Id.*

## Discussion Draft legislation to amend the securities laws to improve private market offerings, and for other purposes.

This discussion draft legislation (1) amends Rule 144 to reduce from 6 to 3 months the mandatory holding period before restricted securities by an SEC reporting company may be resold; (2) allows public resale of restricted securities originally issued by a shell company starting two years after the company files a Form 8-K disclosing that it is no longer a shell; and (3) amends Section 18(b) to include in the definition of "covered securities" any securities offered or sold in compliance with Rule 144A (i.e., sales to Qualified Institutional Buyers).

This bill effectively bypasses the protections in Rule 506 of Regulation D. As proposed, an issuer could generally advertise an offering and sell to accredited investors. In as little as three months, that accredited investor could then sell those securities to unaccredited investors. It has generally been held that holding securities for six months, or for twelve months in the case of non-SEC reporting companies, would negate the inference that the buyer purchased with a view to distribute (rather than hold those securities for investment). We question whether a holding period of only three months would effectively eliminate this well-established position. Moreover, it is in an issuer's best interest to issue shares to as few initial investors as possible. If an issuer can avoid selling those shares to unaccredited, retail investors, and sell only to large institutional investors (i.e., mutual funds, hedge funds, investment banks, etc.), an issuer will choose that route. With the changes proposed by this bill, the large investor could buy the shares at a healthy discount and three months later, dump the stock on average, unaccredited retail investors. We are concerned that the legislation will flood the market with Rule 506 offerings that are unloaded by large sophisticated investors on less sophisticated "mom and pop" investors. Because these are resale transactions, if the business fails or becomes insolvent, the business will have already received the initial money from the large investors, those investors will have received a quick profit, and the retail investors will be left holding worthless shares.

Finally, most states already have an exemption for institutional investors, making the Rule 144A preemption proposed in this draft unwarranted. Moreover, if there are unforeseen problems in this area, preempting the states would eliminate our ability to revise or amend that exemption if necessary. We also have not heard from any of these large investors that state regulation of 144A transactions, if in fact required, has proven problematic.

## Discussion Draft legislation to require the SEC to revise the definition of a well-known seasoned issuer to reduce the worldwide market value threshold under the definition.

This discussion draft legislation would require the SEC to revise its definition of well-known seasoned issuer ("WKSI"), to reduce the public float requirement from $700 million to $250 million. This may allow most issuers to bypass the quiet period restrictions of Section 5(c) of the Securities Act of 1933. Under Section 5 of the Securities Act, all issuers must register non-exempt securities with the SEC; Section 5 also regulates the timeline and distribution process for issuers who offer securities for sale.

The discussion draft would significantly reduce investor protection by preventing the SEC from conducting any pre-offering review of registrations for companies that qualify as WKSIs. It may also prove problematic for issuers who will no longer have the time to conduct a pre-offering "due diligence" review of the registration statement's contents, and thus may be subject to later litigation.

As explained by Professor Coffee, in his testimony before this Subcommittee, this proposed legislation could position EGCs into a status where they simultaneously qualify as a WKSI. This seemingly contradictory—and troubling—result would allow a new Emerging Growth Company ("EGC") to qualify as a well-known seasoned issuer and not be subject to any pre-offering review.

Professor Coffee also suggested that were this bill to become law, WKSIs would be able to register securities for sale for the account of selling shareholders without separately identifying the selling security holders or the securities to be sold by such persons until the time of the actual sale. This facilitates secondary sales by large shareholders, and essentially, according to Prof. Coffee, creates a "bailout by insiders."

NASAA echoes the concerns articulated by Professor Coffee with respect to the proffered discussion draft, and strongly urges Congress to refrain from consideration of such legislation.

## Conclusion

As regulators, states are guided by the principle that every investor deserves protection and an even break and has the right to not be cheated or lied to. As we saw with the passage of National Securities Markets Improvement Act (NSMIA) in 1996, state securities regulators have been handcuffed from reviewing certain offerings before they were sold to members of the public. Since then, a regulatory black hole has emerged to expose investors to high-risk investments offered by companies with little or no financial stability or regulatory scrutiny.

In the 18 years since NSMIA became law, it has become painfully clear that capricious preemption of state review of offerings is a failed experiment. We must not let history repeat itself by creating more regulatory black holes and exposing investors to unacceptable levels of risk and outright fraud, or further dislocating states from our central role in the oversight and stewardship of small business capital formation.

State regulators understand the complex challenges faced by small business issuers. We also understand that a reasonable balance of the issuers' interests and the investors' interests is in the best interest of both groups. It protects the investors, and it facilitates the market for the issuers' securities. If the investors do not trust the small business issuer market, they will not invest.

The states are ready to play an active role in balancing these two interests, and indeed, we are already striving to play such a role.

Thank you again, Chairman Garrett, and Ranking Member Maloney, for the opportunity to testify before the Subcommittee today. I would be pleased to answer any questions you may have.

**Addendum #1**

# NASAA Multi-state Coordinated Review Program

*NASAA has developed streamlined multi-state review protocols for Regulation A+ offerings to ease regulatory compliance costs on small companies seeking to raise capital. With this new program, Regulation A+ filings will be made in one place and distributed electronically to all states. Lead examiners will be appointed as the primary point of contact for a filer and each state will be given 10 business days for review. The lead examiners alone will interact with the issuer to resolve any deficiencies. On January 30, the NASAA Board of Directors approved the Proposed Coordinated Review Program for membership vote by electronic ballot with a March 7 deadline.*

| Filing Process | Review Process | | | | |
|---|---|---|---|---|---|
| Day 1 | 3 business days | 10 business days | 5 business days | 3 business days | Day 21 |
| Issuers desiring coordinated review will e-mail an electronic copy of the application and required exhibits to the program coordinator (State of Washington). The exhibits include Form 1-A & financial statements.<br><br>The program coordinator will distribute the documents to the states selected by the issuer on the application form.<br><br>Filing fees paid directly to each state. | Within three business days after receipt of the application, the program coordinator will select a lead disclosure examiner and lead merit examiner (assuming registration is sought in both types of jurisdictions). | Within an additional 10 business days, the lead examiners will draft and circulate a proposed comment letter to the other disclosure states and/or merit states. | Within an additional five business days, the participating jurisdictions may communicate any concerns or comments to the lead examiners. | Within an additional three business days, the lead examiners will make any necessary revisions and send the initial comment letter to the issuer. | **If there are no deficiencies** in the application, no comments will be necessary and the registration will be cleared by the lead examiners within 21 business days after it is filed.<br><br>**If there are deficiencies**, the lead examiners will communicate with the applicant and the participating jurisdictions to resolve deficiencies. Whenever an issuer files a response to any deficiency, the lead examiners will reply within five business days.<br><br>When a lead examiner determines that the application satisfies all substantive review standards, the examiner will clear the application and provide same-day notice to participating jurisdictions. The lead disclosure examiner and lead merit examiner may clear the application at different times. Each participating jurisdiction agrees to clear the application upon clearance by the lead examiner. |