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NASAA

March 12, 2012

The Honorable Harry M. Reid
Majority Leader
United States Senate
Washington, DC 20510

The Honorable Mitch McConnell
Minority Leader
United States Senate
Washington, DC 20510

Re: Senate Companion to H.R. 3606

Dear Majority Leader Reid and Minority Leader McConnell:

On behalf of the North American Securities Administrators Association (NASAA)[1], I am writing to express concerns regarding several provisions, most notably our strong concern with the extraordinary step of pre-empting state law for "crowdfunding", contained in H.R. 3606, *the Jumpstart Our Business Startups Act*, which was passed by the House of Representatives on March 8, 2011. While NASAA applauds Congress' desire to facilitate access to capital for new and small businesses, the version of the bill that passed the House is deeply flawed. The Senate must now address these problems.

State securities regulators support efforts by Congress to ensure that laws facilitating the raising of capital are modern and efficient, and that Americans are encouraged to raise money to invest in the economy. However, it is critical that in doing so, Congress not discard basic investor protections. Investment fraud is real, and it can be particularly pervasive in small exempted offerings.

Expanded access to capital markets for startups and small businesses can be beneficial, but only insofar as investors can be confident that they are protected, that transparency in the marketplace is preserved, and that investment opportunities are legitimate. State securities regulators are acutely aware of today's difficult economic environment, and its effects on job growth. Small businesses are important to job growth, and to improving the economy. However, by weakening investor protections and placing unnecessary restrictions on the ability of state securities regulators to protect retail investors from the risks associated with smaller, speculative investments, Congress is on the verge of enacting policies that, although

1 The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. 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.

intended to strengthen the economy, will in fact only make it more difficult for small businesses to access investment capital.

The JOBS Act that was passed by the House is a repackaging of what were originally seven bills[2], reorganized into a single bill, with six distinct Titles and twenty-one sections. While NASAA believes virtually every Title of this bill would benefit from greater scrutiny, we will confine our comments today to those Titles and Sections of H.R. 3606 that pose the most urgent risk to average, "Main Street" investors that are NASAA's principal concern.

Title I: The Reopening American Capital Markets to Emerging Growth Companies Act

Title I contains a number of troubling provisions. It creates a new category of issuer referred to as an "emerging growth company", defined as a company with annual gross revenues of less than $1 billion in its most recent fiscal year. This status continues until five years after an initial public offering or until the issuer has an annual gross revenue exceeding $1 billion or is designated a "large accelerated filer." Particularly troublesome to NASAA are the exemptions applicable to such companies: for example, they are exempted from Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX) which requires an independent audit of an assessment of a company's internal controls as well as the requirement to provide three (instead of two) years of audited financials statement in a company's registration materials. S. 1933 also allows brokers and dealers to publish research about emerging growth companies prior to an initial public offering, even where they will participate in the offering itself.

Title I would give all but the very largest companies direct access to average, unsophisticated investors without being required to provide the normal types of financial and risk disclosures applicable to public reporting companies. The typical retail investor, unlike larger business financiers, does not have the ability to conduct an independent investigation of an emerging growth company and make fully informed investment decisions. Such investors rely on published financial and research data. Section 404(b) of SOX was enacted in response to major accounting scandals that cost investors billions of dollars; rolling back these requirements for companies with annual gross revenues of less than $1 billion could, once again, have devastating consequences.

Similarly, weakening the standards applicable to research analysts and tearing down the Chinese walls implemented in response to the "Global Settlement" scandal could create a conflict of interest resulting in devastating losses for Main Street investors. These barriers were put into place in response to enforcement actions brought by a number of state and federal regulators. Leading brokerage firms agreed to severely limit interactions between equity research analysts and investment bankers, due to conflicts of interest that tainted the investment process. Recent experience teaches us now is the time to strengthen the protection of investors, not weaken these standards.

Title II: The Access to Capital for Job Creators Act

<u>Section 201: Modification of Exemption</u>

2 H.R. 3606 as reported by the Committee on Financial Services, H.R. 1070 EH, H.R. 2930 EH, H.R. 2940 EH, H.R. 2170 as reported by the Committee on Financial Services, and H.R. 4088 IH

Sec. 201 of the JOBS Act would repeal the SEC's ban on general solicitation under Regulation D Rule 506 to allow general solicitation in transactions "not involving any public offering, whether or not such transaction involves general solicitation or general advertising."

Current law requires securities offered to the general public to be registered with the SEC. Regulation D was built upon the premise that certain offerings should be given special treatment because they are non-public, or "private." This means that the investment is marketed only to people with whom the company has a preexisting relationship. Given their knowledge of the company and its operations, these investors are in a better position than the general public to gauge the risks of the investment. They, therefore, have less need for the protections that flow from the securities registration process. This concept of giving preferential treatment to private offerings is embedded throughout state and federal securities law, and a reversal of this fundamental condition of Rule 506 would have far-reaching repercussions.

The removal of the "general solicitation" prohibition contemplated by Section 201 would represent a radical change that would dismantle important rules that govern the offering process for securities. NASAA has repeatedly expressed its concern to Congress about allowing general solicitation in rule 506 (Regulation D) offerings. Since the enactment of the National Securities Markets Improvement Act of 1996, Regulation D, Rule 506 offerings have received virtually no regulatory scrutiny, and have become a haven for investment fraud. Moreover, unlike other types of Regulation D offerings, where the size of the offering is capped, the amount of money that an issuer can raise under Rule 506 is unlimited, and hence the opportunity for fraud on a massive scale is especially acute in this area. Given state experience with Regulation D offerings, and the significant fraud and investor losses associated with them, NASAA opposes Section 201.

Because many states already allow issuers to use general advertisements to attract accredited investors, NASAA does not oppose outright the underlying goal of Title II. However, NASAA believes such an expansion should be accomplished by the establishment of a new exemption with provisions to protect investors and the markets.

<u>Section 201: Explanation of Exemption</u> (McHenry Amendment)

During consideration of H.R. 3606 the House adopted an amendment to Section 201[3], sponsored by Rep. Patrick McHenry (R-NC) that will exempt from registration as a broker or dealer any trading-platform that serves as intermediary in an exempted Rule 506 offering. The significance of the McHenry Amendment is to prevent "intermediaries" that facilitate the sale of securities through "crowdfunding" from requirements to register or be regulated as a broker.

NASAA appreciates that the question of how crowdfunding intermediaries may best be regulated is complex, however categorically exempting these sellers from broker registration requirements, in the absence of a sensible alternative for their licensing and regulation, is foolish and reckless. As amended, Section 201 will leave intermediaries open to conflicts, such inducements to list, de-list, or promote certain offerings. Moreover, as amended, Section 201 will deny any regulator effective means to examine or discipline these sellers.

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3 H.Amdt.978, 2nd session, 112th Congress.

Title III: The Entrepreneur Access to Capital Act

Title III of the JOBS Act is identical to H.R. 2930, the Entrepreneur Access to Capital Act, which was approved by the House last fall. Two separate "crowdfunding" bills have been sponsored in the Senate: S. 1791, sponsored by Sen. Scott Brown (R-MA), and S. 1970, sponsored by Sen. Jeff Merkley (D-OR).

While intending to promote an internet-based fundraising technique known as "crowdfunding" as a tool for investment, this legislation will needlessly preempt state securities laws and weaken important investor protections. NASAA appreciates that the concept of crowdfunding is appealing in many respects because it provides small, innovative enterprises access to capital that might not otherwise be available. Indeed, this is precisely the reason that states are now considering adopting a model rule that would establish a more modest exemption for crowdfunding as it is traditionally understood.

Section 301: Individual Investment Limit

Section 301 contemplates a hard-cap on individual crowdfunding investments that goes far beyond anything that is being contemplated by the states, or even by the overwhelming majority of advocates of crowdfunding. By setting an individual investment cap of 10 percent of annual income, or $10,000, Section 301 will create an exemption that will expose many more American families to potentially devastating financial harm.[4]

NASAA recognizes that for certain very wealthy individuals, or seasoned investors, a cap of $10,000 may make sense. Unfortunately, Sec. 301 fails to distinguish between these few wealthy, sophisticated investors, and the general investing public, imposing a $10,000 cap on both groups. Given that most U.S. households have a relatively modest amount of savings, a loss of $10,000, in even a single case, can be financially crippling.

NASAA believes a superior method of limiting individual investment amounts would be a scaled approach that would cap most investments at a modest level, but allow experienced investors, who can afford to sustain higher losses, to invest up to $10,000.

Section 301: Aggregate Offering Limit

Section 301 would also permit businesses to solicit investments of up to $2 million, in increments of $10,000 per investment. Such a high cap on aggregate investment makes the bill inconsistent with the expressed rationale for the crowdfunding exception.

Registration and filing requirements at both the state and federal level exist to protect investors. A company that is sufficiently large to warrant the raising of $2 million in investment capital is also a company that can afford to comply with the applicable registration and filing requirements at both the state and federal level.

Section 303: Preemption of State Law

4 According to the U.S. Department of Labor, the average American household takes in $63,091 per year from income and investments, before taxes, and spends $49,638 a year on a range of necessary and desired expenditures. (Source: Consumer Expenditures, U.S. Bureau of Labor Statistics, April 2010)

Section 303 would preempt state laws requiring disclosures, or reviewing exempted investment offerings, before they are sold to the public. The authority to require such filings is critical to the ability of states to get "under the hood" of an offering to make sure that it is what it says it is. Moreover, as a matter of principle and policy, NASAA ardently believes that the review of offerings of this size should remain primarily the responsibility of the states. State regulators are closer, more accessible, and more in touch with the local and regional economic issues that affect both the issuer and the investor in a small business offering.

Congress would be rash to preempt states from regulating crowdfunding. Preempting state authority is a very serious step and not something that should be undertaken lightly or without careful deliberation, including a thorough examination of all available alternatives. In this case, preemption for a very new and untested concept to raise capital, without a demonstrable history of reliability, is especially unwarranted, as the states have far more experience with crowdfunding than Congress or the SEC, and as the states have historically been the primary "cops on the beat" in the regulation of all areas of small business capital formation.

For a clear example of the dangers of preempting state securities look no further than the effect of the National Securities Markets Improvement Act (NSMIA). As a result of this Congressional action, private offerings receive virtually no regulatory scrutiny. State securities regulators are prohibited from reviewing these offerings prior to their sale to investors, and federal regulators lack the resources to conduct any meaningful review, so the offerings proceed unquestioned. Today, the exemption is being misused to steal millions of dollars from investors through false and misleading representations in offerings that provide the appearance of legitimacy without any meaningful scrutiny of regulators. In essence, the private offering provisions of Rule 506 are being used by unscrupulous promoters to evade review and fly under the radar of justice.

Instead of preempting states, Congress should allow the states to take a leading role in implementing an appropriate regulatory framework for crowdfunding. 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 are the only regulators in a position to police this new market and protect its participants. Moreover, and as has already been noted, the states are now in the midst of developing a Model Crowdfunding Exemption.

As the securities regulators closest to the investing public, and in light of their distinguished record of effective regulation, the States are the most appropriate regulator in this area. State securities regulators are not only capable of acting, but, indeed, are acting in this critical area, and Congress should continue to allow the states to do so.

Title IV: The Small Company Capital Formation Act

Title IV of the JOBS Act is identical to S. 1544, which has been sponsored in the Senate by Sens. Jon Tester (D-MT) and Pat Toomey (R-PA).

Given the risky nature of these offerings, NASAA believes that state oversight is critically important for investor protection. At the same time, NASAA recognizes the costs and difficulty of the typical registration process, and the particular burden it places upon small companies. Indeed, for this reason the states have adopted a streamlined process for an issuer to use in an offering under Regulation A.

NASAA had significant concerns regarding the original version of this legislation because it stripped away investor protection by preempting state review of Regulation A offerings that are sold through broker-dealers. However, Title IV of H.R. 3606 does not include the preemptive provisions that were in the original version of the bill. While NASAA remains concerned about the dollar amount of potential offerings under Title IV, as well as the bill's nonsensical requirement that the SEC automatically increase the ceiling in the future, every two years, in perpetuity, we believe that the states' ability to review these offerings, along with the SEC's proper exercise of discretion in creating reasonable reporting requirements for issuers, will prove to achieve a proper balance of the issuers' needs with investor protection.

Title V: The Private Company Flexibility and Growth Act

Title V of H.R. 3606 would raise the threshold for mandatory registration under the Securities Exchange Act of 1934 (the "Exchange Act") from 500 shareholders to 1,000 shareholders for all companies. This bill would also exclude accredited investors and securities held by shareholders who received such securities under employee compensation plans from the 1,000-shareholder threshold.

Section 12(g) of the Exchange Act requires issuers to register equity securities with the SEC if those securities are held by 500 or more record holders and the company has total assets of more than $10 million. After a company registers with the SEC under Section 12(g), it must comply with all of the Exchange Act's reporting requirements.

The states are primarily interested in the issues related to the regulation of small, non-public companies. We give considerable deference to the SEC in the regulation of public companies and secondary trading. However, we do have concerns about drastic changes in the thresholds for reporting companies or the information they must disclose.

The primary reason for requiring a company to be "public" is to facilitate secondary trading of the company's securities by providing easily-accessible information to potential purchasers. The principal concern for states is the facilitation of this secondary trading market with adequate and accurate information. It may be possible to achieve this without full-blown Exchange Act registration and periodic reporting, but the states are wary of changes that may lead to the creation of less informed markets.

No matter what threshold number is chosen before a company becomes "public," it makes little sense to exclude any investor from the count of beneficial holders. Those that purchased from the issuer were protected by the requirements of the Securities Act. Both the seller and the purchaser benefit from the robust marketplace facilitated by the Exchange Act registration. Accordingly, NASAA believes the registration threshold should be based upon the need to provide for a legitimate secondary trading market. Regardless of where the threshold is set, everyone who is a potential seller in the market should be counted. This would include all beneficial owners, not just holders of record.

Title VI: Capital Expansion

Title VI of H.R. 3606 would raise the threshold for mandatory registration under the Securities Exchange Act of 1934 from 500 shareholders to 2,000 shareholders for all banks and bank holding companies, and raises the shareholder deregistration threshold from 300 shareholders to 1,200 shareholders.

NASAA understands the purpose of Title VI is to remedy a specific problem that is today confronting certain community banks. Specifically, as a result of the increasing costs of public company registration, many community banks have determined that deregistration is in the best interests of their shareholders. But in order to deregister, community banks must have fewer than 300 shareholders. As a result, community banks must often buy back shares to deregister, which reduces the access of small banks to capital and deprives small communities of an opportunity to invest in local companies.

Given the narrow scope of this Title and its application to only banks and bank holding companies, NASAA has no position on Title VI.

Finally, in view of the significant changes that H.R. 3606 would make to our securities laws, and of the fundamentally experimental nature of many of this bill's provisions, NASAA urges that H.R. 3606 proceed through the Senate under regular order, and that the bill be subject to the scrutiny of the Senate Banking Committee and it Securities Subcommittee. Securities regulators, legal scholars, investor advocates, and others have cautioned the Senate about the impact H.R. 3606 could have on investors and on our capital markets. The Senate must answer these questions and concerns, thoroughly and to its satisfaction, before it votes on H.R. 3606 or similar legislation.

Thank you for your consideration of these important issues. If you have any questions, please feel free to contact Michael Canning, Director of Policy, or Anya Coverman, Assistant Director of Policy, at the NASAA Corporate Office at (202) 737-0900.

Respectfully,

Jack E. Herstein
NASAA President
Assistant Director, Nebraska Department of Banking & Finance, Bureau of Securities