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and

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Before the

Senate Committee on Banking, Housing, and Urban Affairs

"Spurring Job Growth Through Capital Formation While Protecting Investors"

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Introduction

Good morning Chairman Johnson, Ranking Member Shelby, and members of the Committee, I'm Jack Herstein, Assistant Director of the Nebraska Department of Banking and Finance, Bureau of Securities and President of the North American Securities Administrators Association, Inc. ("NASAA"). NASAA is the association of state and provincial securities regulators.

State securities regulators have protected Main Street investors for the past 100 years, longer than any other securities regulator. State securities regulators continue to focus on protecting retail investors more so than any other regulator. Our primary goal and mission is to act for the protection of investors, especially those who lack the expertise, experience, and resources to protect their own interests.

The securities administrators in your home states 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.

Ten of my colleagues are appointed by state Secretaries of State; five are under the jurisdiction of their states' Attorneys General. Some are appointed by their Governors and Cabinet officials. Some, like me, are employed by state government departments or state agencies. Others work for independent commissions or boards.

States are the undisputed leaders in criminal prosecutions of securities violators. In 2010 alone, state securities regulators conducted more than 7,000 investigations, leading to nearly 3,500 enforcement actions, including more than 1,100 criminal actions. Moreover, in 2010, more than 3,200 licenses of brokers and investment advisers were withdrawn, denied, revoked, suspended, or conditioned due to state action.

Investor Protection and Job Creation

State securities regulators are acutely aware of the present economic environment and its effects on job growth.

In Nebraska, I see and also hear about the recession's lingering impact on small business on a daily basis and these effects can be devastating. Neither I nor any other state securities regulator seeks to inhibit economic growth through regulation that is overly burdensome or restrictive. To the contrary, Nebraska and other states are committed to fostering responsible job growth through capital formation because we believe small businesses are indispensible to a strong economy.

At the same time, as a securities regulator, I have for 34 years observed the profound and negative consequences of securities fraud and undisclosed investment risks on individuals and families, and on healthy and functional markets.

In much the same way small business investment has the potential to be a very positive economic force and a major driver of wealth and jobs when done in the right way, such investment also has the potential to become a costly failure that undermines market health and discipline, and places middle income investors at an extreme risk if done without appropriate oversight. The key is balancing the legitimate interests of investors with the legitimate goals of entrepreneurs, and pursuing policies that are fair to both.

The success of small business is, in many respects, America's success, and one of the things we will need to do to get America moving forward again is to encourage small business growth and entrepreneurship. In the midst of a prolonged period of high unemployment and slow economic growth, this appeal grows even stronger. Many of us have seen businesses disappear since the financial crisis, not due to the inability to compete, or due to shortcomings in their business plan or the goods and services they produce, but due to their inability to get loans from banks.

The challenge for Congress today is to find policies that achieve the right balance between the objectives of promoting investment in valid business opportunities and protecting investors. Finding the right balance may be difficult, but the states stand ready to work with Congress and the SEC to ensure that this balance is achieved.

Principles for the Regulation of Small Business Investment

Before I discuss specific proposals pending before the Committee, I want to outline the several overarching principles that inform NASAA's thinking in this important area.

First, Congress should refrain from preempting state law. 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.

Securities regulation is a complementary regime of both state and federal law. Several of the proposals under consideration by Congress would needlessly and capriciously preempt state law. The exact opposite is better public policy. A decrease of federal regulation in this area may be appropriate, but the states should continue to have the authority and flexibility to provide appropriate oversight because small business capital formation is a matter of grave concern at the state level. State securities regulators have no interest in throwing up needless roadblocks for small businesses. In fact, we are interested in creative ways to spur economic development and job creation.

Second, while Congress' desire to facilitate access to capital for new and small businesses is warranted, it must be sure do so in a careful and deliberate fashion.

Expanded access to capital markets is beneficial only insofar as investors remain confident that they are protected, transparency in the marketplace is preserved, and their investments are legitimate. Such assurances promote investor confidence, which is the key to the growth that Congress wants to encourage. If investors have no faith that small business offerings are being regulated to their satisfaction, they will be unlikely to invest their capital in these companies, and our efforts to facilitate growth through providing additional avenues of capital formation by small business will be in vain.

Third, Main Street investors should not be treated as the easiest source of funds for the most speculative business ventures. The law should not provide lesser protections to the investors who can least afford to lose their money.

Some of the proposed legislation before the committee would give unproven companies direct access to small, unsophisticated investors without being required to provide the normal types of financial and risk disclosures. If a company cannot get financing from a bank, an SBA loan, a venture capital fund, or even friends and family, it is probably because there is a significant risk that the investment is extremely risky. The critical questions are: *Have these sources stopped funding small businesses? If so, why?*

The answers to these questions should dictate the universe of proposals Congress should entertain.

If the answer is that funding is not available because banks are not lending as they should, or because traditional sources of small business capital are unavailable even to well-qualified, established, or very promising small business endeavors, then this has the potential to stifle small business growth and hurt the economy. Therefore, Congress might consider certain steps to minimize or remediate this needless loss of productivity.

On the other hand, if the answer is that traditional sources of small business capital have reviewed the particular small business applicant and determined that the risk is too great, then we should not allow that applicant to seek investment from unsophisticated, “mom and pop” investors without appropriate investor protections. The typical retail investor, unlike the traditional small business financier, does not have the ability to conduct a reasonable investigation of a start-up or development-stage entity.

NASAA Comments on Specific Legislation Pending Before the Senate

In addition to the general priorities I articulated a moment ago, NASAA offers the following observations and suggestions regarding several bills that are now pending before the Senate and the Committee on Banking, Housing and Urban Affairs.

I. Establishment of a Registration Exemption for "Crowd-funding" Securities (H.R. 2930, S. 1791)

Several bills recently introduced in the House and Senate would create a registration exemption for securities offerings made by "crowdfunding." Because there are important distinctions between each of these bills, I believe it is appropriate for NASAA to comment on them individually.

The Entrepreneur Access to Capital Act (H.R. 2930)

On November 3rd, 2011 the House of Representatives voted to pass H.R. 2930, the Entrepreneur Access to Capital Act, in a remarkable seven weeks after its introduction on September 14. The bill would create a new exemption from SEC registration for an offering amount up to $2 million ($1 million if the company does not have audited financial statements), with a maximum of $10,000 per investor (or ten percent of the investor's annual income). The bill would treat these offerings as "covered securities" thereby preempting state authority to register the securities.

If this legislation is enacted in its current form, it will prohibit states from enforcing laws designed to minimize the risks to investors. By expressly preempting state law for the new crowdfunding exemption created under the legislation, it leaves a massive hole in the investor protection safety net. 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. Post-sale anti-fraud remedies provide little comfort to an investor who has lost a significant sum of money that is unrecoverable. This is a fundamental concern that states have had with HR 2930 since its introduction.

NASAA recognizes the need for small businesses to access capital in innovative ways that reflect modern realities, but we believe the exemption that would be established by H.R. 2930 is far too broad. The thresholds for individual investment and aggregate offerings set by H.R. 2930 are far higher than those sought by most advocates of crowdfunding and, as a result, small investors are exposed to the danger of considerable losses in these highly risky investments. A 2009 survey by the Employee Benefits Research Institute indicated that 53 percent of American households had less than $25,000 in total savings and investments[1], so a $10,000 loss would be crippling to these households.

The Democratizing Access to Capital Act (Sen. Scott Brown - S.1791)

The Democratizing Access to Capital Act differs from H.R.2930 in several important respects. First, under S. 1791, individual investments in crowdfunding are limited to $1,000 per person, per year, with an aggregate offering cap of $1 million. In addition, S. 1791 provides that in order to raise money through crowdfunding under a federal exemption, the entity raising the money must be incorporated under, and subject to, State law, and a "crowdfunding intermediary" must be used.

S. 1791 represents a considerable improvement from H.R. 2930. Indeed, S. 1791 is in many respects similar to the framework for a model state-level exemption for crowdfunding that is described below.

State Model Rule with Corresponding Federal Exemption

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

[1] According to the Employee Benefits Research Institute's 2009 Retirement Confidence Survey, 53% of workers in the U.S. have less than $25,000 in total savings and investments. http://www.ebri.org/files/FS-03_RCS-09_Saving.FINAL.pdf

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.

In short, the oversight of these offerings should be done by state regulators.

If regulatory authority is preserved for the states, NASAA will pursue the development of a model exemption for crowdfunding that uses many of the components of S. 1791. We have completed an initial draft of a model exemption that includes the following elements:

- An aggregate offering amount to $500,000 over a twelve month period.
- Individual investments are limited to $1,000 per year, per offering.
- It uses a one-stop filing in the state of the issuer's principal place of business. The issuer must provide the home state with contact information and other basic information about the company, and the home state will share the information with other states upon request.
- The issuer has the choice whether to use an intermediary or not.
- To inform investors, the issuer must make basic disclosures on its website, including its business plan and proposed use of proceeds. Boilerplate language will be developed to provide investors with important information about the general investment risks of crowdfunding.
- The issuer will be required to escrow investor proceeds until it reaches at least 60 percent of the target investment amount.
- Individuals and companies that have criminal records or have violated securities laws will be precluded from using the exemption.

State securities regulators fully understand the need for small businesses to raise capital and create jobs, and we are willing to accommodate small issuers by creating this very innovative type of exemption. But we also recognize that small business offerings are usually high risk, and there is the potential for significant fraud in this market. To maintain an appropriate balance between investor protection and legitimate capital formation, we believe it is crucial that the states keep their authority over these offerings. The states are the regulator positioned to provide a modicum of investor protection by ensuring that the company exists, that its principals are not bad actors, and that basic disclosures are made to our investors.

II. Removal of the Prohibition on General Solicitation in Regulation D Offerings (H.R. 2940, S. 1831)

On November 3rd, 2011 the House of Representatives voted to pass H.R. 2940, the Access to Capital for Job Creators Act. This legislation, along with identical companion legislation introduced in the Senate by Sen. John Thune (S. 1831), would eliminate the ban on "general solicitation" in non-public offerings.

Current law requires that securities offerings to the general public 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 H.R. 2940 and S. 1831 would represent a radical change that would dismantle important rules that govern the offering process for securities. However, because many states already allow issuers to use general advertisements to attract accredited investors, NASAA does not oppose outright the underlying goal of H.R. 2940.

H.R. 2940 as modified by the "Garrett Amendment"

NASAA believes it is critical to call the Committee's attention to an amendment to H.R. 2940 that was added to the bill during its consideration by the House Financial Services Subcommittee on Capital Markets. Unfortunately, in the course of its consideration by the House, an amendment sponsored by Rep. Scott Garrett resulted, in the introduction of deeply problematic changes to H.R. 2940.

As introduced, H.R. 2940 would have repealed only the ban on general solicitation of accredited investors in offerings made under Rule 506. The Garrett Amendment expanded application of the bill to Section 4(2) of the Securities Act. Thus, in its current form, H.R. 2940 would amend Section 4(2) to provide an exemption for transactions "not involving any public offering, *whether or not such transaction involve general solicitation or general advertising*." Permitting the public solicitation of investors in an offering that, under law, is deemed a "non-public" offering is inconsistent. Therefore, NASAA respectfully suggests that a better approach would be to adopt an entirely new exemption under federal law to permit general solicitation of accredited investors.

The MAIE as an alternative to H.R. 2940

One alternative to H.R. 2940 would be to make federal use of the Model Accredited Investor Exemption ("MAIE"), which already provides a way under state law for issuers to find accredited investors through a more public offering by allowing an issuer to use a general advertisement to "test the waters" for a proposed offering.[2] There is no limit on the number of investors under the MAIE, and there is no limit on the amount an issuer may raise in an offering under the MAIE. Although only accredited investors may purchase securities offered through the MAIE, dissemination of the general announcement to non-accredited investors will not disqualify the issuer from claiming the exemption.

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[2] The MAIE was adopted by NASAA in 1997 and has been adopted by the majority of states, but its utility is very limited because a corresponding federal exemption has never been adopted by Congress or the SEC.

A federal equivalent of the MAIE, with modifications to reflect modern modes of communication, would accomplish the goal of broadening issuers' access to accredited investors. NASAA believes this approach is far better than the approach of H.R. 2940, which undermines the "non-public" foundation of Section 4(2) and Regulation D.

If the Committee prefers to move forward with H.R. 2940, however, it should at a minimum remove the Garrett Amendment or section 2(a) of the bill. It is one thing to allow general solicitation of accredited investors within the confines of an offering otherwise conducted in accordance with Rule 506, but it's quite another to allow a general solicitation for all offerings made in reliance on Section 4(2).

III. Increase of the limit on Regulation A offerings from $5 million to $50 million (H.R. 1070, S. 1544)

On November 2, 2011 the House of Representatives voted to pass H.R. 1070, the Small Company Capital Formation Act. Identical companion legislation (S. 1544) has been sponsored in the Senate by Sen. John Tester of Montana.

Under current law, offerings conducted in accordance with Regulation A are subject to the registration requirements of state law. Given the risky nature of these offerings, NASAA believes state oversight is critically important for investor protection. However, we also recognize the cost and difficulty of the typical registration process, and the particular burden it places upon small companies, so we adopted a streamlined process for an issuer to use in an offering under Regulation A. We developed a "Small Company Offering Registration" form that uses a fill-in-the-blank and question-and-answer format to guide a small issuer through the preparation of an adequate disclosure document.

NASAA had significant concerns regarding the original version of H.R. 1070 because it stripped away investor protection by preempting state review of Regulation A offerings that are sold through broker-dealers. However, Representative Schweikert agreed to remove the preemptive provisions of his bill prior to its passage by the House, and the counterpart bill sponsored by Sen. Tester in the Senate never included such provisions.

NASAA harbors some concerns regarding the dollar amount of potential offerings under H.R. 1070. Nonetheless, 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. Accordingly, NASAA does not oppose H.R. 1070 or S. 1544.

IV. Raise the number of shareholders of record for registration with the SEC (H.R. 2167)

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.[3]

On October 24, 2011, the House Financial Services Committee voted to favorably report the Private Company Flexibility and Growth Act (H.R. 2167), which 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.

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. Investors and the markets depend

[3] The reporting requirements include filing annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and proxy statements on Schedule 14A.

upon access to information that public companies are currently required to disclose, and drastic changes could be disruptive and harmful.

The question of an appropriate registration threshold should not just consider the cost to the issuer, but also the cost to investors and the impact on the integrity of the U.S. markets. Giving smaller companies the ability to disclose less information may be counterproductive because it could diminish investor confidence in the markets or drive investors to the larger companies that are required to be more transparent.

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. Because the Exchange Act registration and periodic reporting requirements are designed to protect and inform purchasers in the secondary trading market, a company's obligation to become an Exchange Act filer should be based upon the need for liquidity in such a market. Determining this need requires an assessment of the potential activity in the secondary trading market. This activity is best measured by the count of beneficial holders, not record holders, and would include all accredited investors, employees, and crowdfunding investors, because they will be active in the secondary trading market.

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. The Exchange Act, and Section 12(g), serves a different purpose – providing a trustworthy, truthful marketplace so that shareholders have liquidity and that secondary buyers have adequate information upon which to make their purchase decision. Accordingly, it makes no difference that the seller in this market is an accredited investor or an employee. Both the seller and the purchaser benefit from the robust marketplace facilitated by the Exchange Act registration.

In short, 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.

V. Raising the threshold of record holders that triggers registration for banks and bank holding companies.
(H.R. 1965, S. 556)

On November 2, 2011 the House of Representatives voted to pass H.R. 1965, which would amend Section 12(g) of the Exchange Act by raising the threshold that triggers registration from 500 to 2,000 record holders for banks or bank holding companies. The bill would also modify the threshold for deregistration under Sections 12(g) and 15(d) of the Exchange Act for a bank or a bank holding company from 300 to 1,200 shareholders. The bill is a companion to a Senate bill (S. 556) by Sen. Kay Bailey Hutchison (R-TX) and Sen. Mark Pryor (D-AR).

NASAA understands H.R. 1965 to be a bill designed to remedy a unique and 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 the bill and its application only to banks and bank holding companies, NASAA has not taken any position on H.R. 1965 or its Senate companion.

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 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 15 years since the National Securities Markets Improvement Act of 1996 became law, it has become painfully clear that 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.

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. We believe that reasonable registration or exemption provisions can be adopted that benefit only those issuers for which they are designed, disqualify "bad boys", and provide for reasonable investor qualifications and protections. Further, we remain adamant that these provisions must preserve the ability of states to protect the interests of investors.

Thank you again, Mr. Chairman, for the opportunity to testify before the Committee today. I will be pleased to answer any questions you may have.