WRITTEN STATEMENT OF

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BEFORE THE

SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

"*Venture Exchanges and Small-Cap Companies*"

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Chairman Crapo, Ranking Member Warner, and Members of this Subcommittee, on behalf of the North American Securities Administrators Association, Inc. (NASAA), I am pleased to submit this statement to the Senate Committee on Banking, Housing, and Urban Affairs for inclusion in the record of the hearing entitled "Venture Exchanges and Small-Cap Companies," held on March 10, 2015 by the Subcommittee on Securities, Investment, and Insurance.

Introduction

NASAA was organized in 1919, and is the oldest international organization devoted to investor protection. 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, and its mission is to serve as the voice of securities agencies responsible for grassroots investor protection and efficient capital formation.

State securities regulators have protected Main Street investors for the past 100 years, longer than any other securities regulator. Ten state securities regulators are appointed by Secretaries of State, five are under the jurisdiction of their states' Attorney General, several are appointed by their Governors and cabinet officials and others work for independent commissions or boards. State securities regulators closely interact with the business community and investors in their state, fostering a collaborative relationship with compliant registrants through accessibility and communication.

Collectively and individually, state securities regulators enforce state securities laws by investigating suspected investment fraud, and, where warranted, pursuing enforcement actions that may result in fines, restitution to investors and jail time. State securities regulators ensure honest financial markets by licensing registrants – both firms and investment professionals – and conducting ongoing compliance inspections and examinations. They work with issuers to ensure that securities offerings include legally required disclosures, thus resulting in a transparent and fluid securities markets.

Evaluating Proposals for a New Generation of "Venture Exchanges"

State securities regulators understand the current interest by Congress and others in the establishment of a new generation of exchanges, referred to as "venture exchanges," that could list the shares of smaller, emerging companies. We strongly share Congress's interest in considering ways to improve access to capital for those companies. Indeed, many states are undertaking efforts to facilitate small business capital formation by fashioning intrastate exemptions for "crowdfunding" and other innovative ways to raise capital.[1]

[1] Since 2011, sixteen states and the District of Columbia have enacted state-based crowdfunding laws or regulations and other forms of limited offering exemptions for small businesses, through exemptions and registrations. These jurisdictions include Alabama, the District of Columbia, Georgia, Idaho, Indiana, Kansas, Maine, Maryland, Massachusetts, Michigan, Nebraska, Oregon, Tennessee, Texas, Vermont, Washington, and Wisconsin. *See* www.nasaa.org/industry resources/corporationfinance/instrastate-crowdfunding-resource-center/.

Congress should examine the policy rationale for "venture exchanges"

There are many ways that new and growing businesses can access investment capital. In the early stages, this may include borrowing from friends and family, commercial loans, and increasingly, accessing investment capital through crowdfunding. For the most promising start-ups, investment capital also can be accessed from angel investors, venture capital and private equity firms.

Given these available sources of capital, the question becomes, what is the additive value of venture exchanges, which are by definition more opaque, less efficient, more volatile, and more illiquid than U.S. public markets, which continue to be the envy of the world?

We urge Congress to understand and examine the policy rationales for establishing "venture exchanges" for small and unestablished companies. While it is unclear how venture exchanges would augment the many tools available to provide capital to businesses, it is readily evident that establishing such exchanges could pose a risk to investors and the capital they invest in those markets. Indeed, the central features of the proposed "venture exchanges" – newer, untested companies, reduced disclosure, limited liquidity, and comparatively high rates of failure or bankruptcy and investment loss – sharply contrast with the robust disclosure and transparency regime that define America's modern and efficient capital markets.

A major driver of recent proposals to establish new types of exchanges, generally with relaxed disclosures and listing standards, appears to be the desire to exempt securities traded on a venture exchange from regulations such as Unlisted Trading Privileges and National Market System rules. While NASAA members generally agree that some relief may be necessary and appropriate for the success of a venture exchange, we are concerned about the effects and extent of such relief. We believe further discussion of the regulatory relief that is sought from these regulations is necessary.

Further, before proceeding with legislation that may not facilitate a robust trading market for smaller, emerging companies, NASAA believes that a further study should completed. One way to gather additional information would be to endorse Commissioner Stein's recent suggestion and to direct the SEC to publish a concept release on this topic.[2] This would also allow broad public participation in this important dialogue.

Finally, Congress should undertake a broadening of its own and the public's understanding of the proposed "venture exchanges." It should identify the investors that these exchanges would serve, and determine whether and why such investors are not optimally served by existing exchanges and other capital raising tools. Above all, prior to enacting any legislation, Congress should carefully consider the impact of "venture exchanges" on the investing public.

[2] Written Remarks of SEC Commissioner Kara M. Stein. "Supporting Innovation Through the Commission's Mission to Facilitate Capital Formation." Stanford Law School. Stanford, CA. March 5, 2015. *Available at* http://www.sec.gov/news/speech/innovation-through-facilitating-capital-formation.html#.VPvO2PzF97w.

Additional Policy Considerations for "Venture Exchanges"

NASAA firmly believes that Congress and other interested stakeholders should be analyzing and studying the benefits and challenges to making venture exchanges a successful proposition for both companies and the investing public. However, at the suggestion of members of the Subcommittee, the Committee staff, and other interested parties, we focus the remainder of this statement on certain specific policy challenges inherent in establishing venture exchange for small and lightly traded companies.

1. What federal authority should regulate a "venture exchange"?

Current law allows the creation of new exchanges, including exchanges targeted to smaller companies. Today, there are many national exchanges registered with the SEC and that operate with varied listing requirements.[3] In addition to traditional national exchanges, various alternative marketplaces exist, such as the OTCQX, OTCQB, and OTC Pink. In fact, OTC Markets refers to the OTCQB as "The Venture Marketplace." It is not clear why, or if, new legislation or regulatory relief would be necessary to foster the creation of such an exchange.

2. Will enacting new legislation lead to the creation of new exchanges?

It is uncertain whether any venture exchange will be created, or succeed, with the enactment of new legislation. Over the past 80 years, more than 20 regional stock exchanges either have gone out of business or merged with other exchanges to stay afloat.[4] One of the last regional exchanges to close, the Spokane Stock Exchange, shut down on May 24, 1991 after broker loyalty vanished for one of the few remaining regional mining exchanges in the United States. The fact that a so-called "venture exchange" does not already exist may be due to financial viability as opposed to regulation.

3. Are there baseline standards that must remain a part of any "scaled" disclosure?

Enacting legislation that is focused on facilitating the creation of exchanges with low listing standards or regulatory requirements may facilitate fraud at the expense of retail investors. Regulation is an essential component to maintaining investor confidence in the market, which ultimately fuels economic growth and job creation. The key to success will be to scale listing standards to the size of the enterprise while ensuring appropriate protections are in place to avoid

[3] The SEC registers "national securities exchanges" under Section 6 of the Securities Exchange Act of 1934. *See* http://www.sec.gov/divisions/marketreg/mrexchanges.shtml.

[4] Regional stock exchanges are exchanges that trade shares of companies that cannot meet the strict listing requirements of national exchanges may qualify to trade on regional exchanges. A partial list of former regional exchanges now closed includes: Baltimore, MD (1949), Buffalo, NY (1936), Cleveland, which merged with Chicago (1949), Colorado Springs (1966), Denver, CO (1936), Detroit, MN (1976), Hartford, CT (1934), Honolulu, HI (1977), Louisville, KY (1935), Milwaukee, WI (1938), Minneapolis, MN, which merged with Chicago (1949), New Orleans, LA, which merged with Chicago (1959), Pittsburgh, PA, which merged with Philadelphia (1969), Richmond, VA (1972), St. Louis, MO (1949), Salt Lake City, (1986), Seattle, WA (1942), Spokane, WA (1991), Washington, D.C., which merged with Philadelphia (1953), Wheeling, WV (1965)

fraud. We believe an essential component in a baseline standard must also include investor qualifications for participation.

4. Preemption of state review of listed securities:

A listing on national securities exchanges affords securities "covered security" status such that state registration requirements are preempted. Less stringent exchanges do not provide this status to securities (e.g., the Miami International Securities Exchange). The appropriate balance was struck regarding the level of rigorousness in listing standards that would afford "covered security" status and preemption of state law in 1996 with the enactment of the National Securities Markets Improvement Act (NSMIA). However, since that time, new exchanges have formed and some of these have been recognized as exchanges for which a listing will provide securities "covered security" status (e.g., BATS Global Markets exchange).[5]

Preemption should not attach to securities based on a listing on an exchange that does not have rigorous listing standards. Where an exchange does not qualify for "covered security" status, secondary trading exemptions are available in the majority of states, e.g., a manual exemption. Manual exemptions facilitate secondary trading while providing for important investor protections. We believe the current regime between federal and state level review is sufficient.

5. Trading volume:

Companies who do not satisfy minimum trading volumes should be delisted from any future venture exchange as such a listing may mislead investors that an active trading market exists and can otherwise be used as a mechanism to perpetrate fraud. The appropriate trading volume requirements should be determined after a thorough study of trading volumes on the TSX Venture Exchange and the London Stock Exchange's AIM.

6. Reporting:

There must be current financial statements and other company information available for investors to be able to make an informed investment decision. Transparency and quality information are essential. These should include, at a minimum, audited annual financial statements, quarterly reports, and material event reports.

For additional information about how frequently small companies listed on venture exchanges have reporting problems, fraud, and other issues, when compared with companies listed on more established securities exchanges, NASAA invites the Committee to consult a recent report on "Venture Exchanges and Investor Returns" published by the CFA Institute. The CFA Institute's report notes that "Small companies should be afforded access to capital markets

[5] See. Sec. 18 and Rule 146.

to fund their growth and development, but they should provide investors the transparency and quality of information required for informed decisions and appropriate investor protections."[6]

7. Preemption:

Sec. 18 and Rule 146 already provide for preemption based on appropriately rigorous listing standards. Preemption should not attach to securities based on a listing on an exchange that does not have rigorous listing standards.

8. Treatment of companies that fall below listing requirements:

There should be a mechanism to remove companies that fall below the listing standards. Shell or non-operating companies, for example, are often a mechanism for fraud. Indeed, since 2012, the SEC has suspended trading of more than 800 microcap stocks, including 128 earlier this month. According to the SEC, these actions reflect the Commission's desire to "prevent fraudsters from having the opportunity to manipulate these thinly-traded stocks by pumping the companies' stock value through false and misleading promotional campaigns and then dumping the stocks after investors buy in."[7]

9. Is it premature to enact legislation for the creation of a market catering specifically to Regulation A securities?

Securities offered and sold under Regulation A may currently apply for listing on an existing exchange. Existing exchanges have not elected to create specialized markets for Regulation A securities and it is unclear that such specialized markets would be created as a result of new legislation.

10. Are there lessons that proposed "venture exchanges" can take from other markets, including foreign venture exchanges?

It is important to note that other markets, specifically foreign venture exchanges, are not unregulated marketplaces. These exchanges explicitly acknowledge that regulation is the key to success for both the exchange and the companies that trade on them. Any "venture exchange" legislation should be based on a study of those markets and their successes and failures.

Prior regional exchanges and the existing venture exchanges became focused on a particular industry or region, thereby magnifying economic downturns in those markets or regions. One way to avoid this risk in any future legislation would be to prohibit venture exchanges from denying a listing based on a company's business location within the United States or based on the company's industry of operations. This would help to guarantee that trading could be centralized

[6] The CFA Institute. "ISSUE BRIEF: VENTURE EXCHANGES AND INVESTOR RETURNS: A New Look at Reporting Issues, Fraud, and Other Problems by Exchange." December 5, 2011. *Available at* http://www.cfainstitute.org/ethics/Documents/venture_exchange_issue_brief_final.pdf.

[7] U.S. Securities and Exchange Commission. "Press Release: SEC Suspends Trading in 128 Dormant Shell Companies to Put Them Out of Reach of Microcap Fraudsters." Washington D.C., March 2, 2015. *Available at* http://www.sec.gov/news/pressrelease/2015-44.html#.VP3SKPnF98E.

in one or a small number of exchanges whose diversity of listings would better ensure the success of those exchanges.

Conclusion

Just as there are lingering questions about the policy basis for establishing additional exchanges whose primary selling point would be inferior listing and disclosure standards, there are obvious questions about the business model that would be required to support such an exchange. In recent decades, a large number of smaller exchanges have gone out of business, and the reason that no so-called "venture exchange" exists in the U.S. today may be more a function of inadequate financial viability as opposed to regulatory policy.

Venture exchanges have the potential to be very risky for certain investors.

No matter how effective the regulatory scheme for a venture exchange, securities that trade on such proposed exchanges will be significantly more risky investments than securities issued by public companies traded on a major national exchange. Congress should act with this in mind, and should thoroughly examine all of the issues NASAA and others have raised at today's hearing.

State securities administrators appreciate the opportunity to comment on the concept of "venture exchanges." We look forward to continuing to work the Senate Banking Committee, its members, and others in Congress to explore new exchanges, and other areas where state and federal regulators and policymakers might partner to promote greater access to investment capital consistent with responsible investor protection. We urge Congress to continue its engagement with relevant stakeholders including state and federal securities regulators as they explore this issue.