SPEECH

Promoting Investor Protection in Small Business Capital Formation

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Today, the Commission proposes rules to implement Title IV of the JOBS Act.[1] As mandated by that Act, the proposed rule would allow companies to issue a class of securities that are exempted from the registration and prospectus requirements of the Securities Act, provided that certain conditions are met.[2] This is the third major rulemaking undertaken by the Commission to comply with the JOBS Act since its adoption last year.[3]

Enhancements to Investor Protection under Regulation A-plus

The proposed rules being considered today enhance an existing exemptive regime known as Regulation A. Under the current provisions of Regulation A, companies can raise up to $5 million per year without registration, provided that they file an offering statement with the Commission containing certain required information and furnish an offering circular to purchasers, among other conditions.[4]

Today's proposal, often referred to as "Regulation A-plus," would extend this exemption to issuances of up to $50 million in any 12-month period, while at the same time increasing investor protection for offerings above $5 million (referred to in the proposal as "Tier 2" offerings) in four important ways:

- First, by enhancing disclosure requirements, and by requiring companies to include audited financial statements in their offering circulars;
- Second, by ensuring that the Commission staff has an opportunity to review and comment on the offering circular before it becomes effective;
- Third, by limiting the amount of securities that a potential investor may invest to 10% of the investor's annual income or net worth, whichever is greater; and
- Fourth, by requiring companies that issue a class of securities under Regulation A-plus to file ongoing disclosure reports, so long as the securities are held of record by at least 300 investors.[5]

Given the $50 million limit on offerings under Regulation A-plus, the offering statement and ongoing disclosure reports required by the proposed rules are focused on the types of information that the staff's experience suggests are relevant to smaller companies and their investors. As a result, the required disclosure, while valuable, is less extensive than the disclosure required in a registered offering. In that regard, I encourage commenters, and in particular investors with experience investing in smaller companies, to comment in detail about the specific disclosures that would be valuable to require in offering circulars and reports under revised Regulation A.

It is my hope that the final disclosure requirements will protect and inform investors, resulting in the investor confidence necessary for the success of Regulation A-plus, while at the same time providing an appropriate alternative to registered offerings for those small and emerging

companies that need access to public capital to grow and create jobs.[6]

The Role of the States

Today's release also addresses the issue of preempting state blue sky review for Regulation A-plus offerings, as provided for in Section 401(b) of the JOBS Act.[7] One way the statute enables preemption is by authorizing the Commission to adopt a definition of "qualified purchaser" with respect to such offerings, as offers and sales to qualified purchasers would be exempt from state registration or qualification.[8] To that end, today's proposal would define "qualified purchaser" to include all offerees, and all purchasers in "Tier 2" offerings.[9] In other words, the proposed rule defines "qualified purchaser" in a way that would preempt all Tier 2 offerings from state blue sky requirements—although state securities commissions would nevertheless retain jurisdiction to investigate and bring enforcement actions in the case of any fraud or deceit.

However, as the Commission acknowledges in the proposing release,[10] the North American Securities Administrators Association—known as NASAA—recently proposed a coordinated process to streamline review of Regulation A offerings.[11] This new streamlined protocol could substantially reduce state securities law compliance hurdles for Regulation A issuers by reducing the cost and time frame associated with state review.[12] In that regard, the proposing release solicits comments on potential alternative approaches to the definition of "qualified purchaser"[13] that would take into account possible state review.[14]

The Commission is mindful of the important role that state securities administrators play in protecting investors and promoting capital formation, particularly with respect to smaller offerings.[15] It has long been recognized that the states are on the "front lines" of antifraud enforcement for smaller offerings.[16] Moreover, the states have a history of working closely with issuers and investors in their jurisdictions, and have extensive experience reviewing small offerings.[17] This is important expertise and experience to incorporate into the process. Accordingly, I look forward to NASAA and the state regulators completing their work to implement a workable protocol for state review of offerings under Regulation A, and I urge both investors and other interested parties to comment on the pros and cons of incorporating a form of state review into the Regulation A qualification process.

Ongoing Reporting and Secondary Trading

Before concluding, it is important to note that, in accordance with the statute, securities issued pursuant to Regulation A-plus will not be restricted securities, and will thus be freely tradeable by security holders who are not affiliates of the issuer.[18] Accordingly, the ongoing reporting requirements in the proposed rules provide an important protection for investors in securities issued pursuant to Tier 2 of Regulation A.

It cannot yet be known whether a reliable secondary market will develop for Regulation A securities. However, even with the proposed reporting requirements, the market for such securities will almost certainly be less transparent than the market for listed securities. In addition, given the smaller offering size and reduced transparency, Regulation A securities may experience wider spreads, lower liquidity, and the potential for significant volatility as compared to registered securities, in any secondary trading markets that may develop.

Although the JOBS Act is silent regarding what actions can be taken to mitigate the risks to investors that may result from such a trading environment, the Commission must be proactive in addressing foreseeable consequences.

In that regard, I expect the staff to actively monitor any secondary trading activity that develops after adoption with respect to Regulation A securities, for any possible indications of

fraud, manipulation, or market failure. The rule changes we propose today will not achieve the hoped for benefits in capital formation, if the end result is that investors are left holding a portfolio of securities that cannot be valued or sold.

Notably, Regulation A-plus is just one of several initiatives under the JOBS Act that raises this issue. Other JOBS Act provisions may also increase the number of companies that are exempt from the registration and reporting requirements of the Exchange Act, but still have significant security holdings in public hands. For example, the availability of general solicitation and advertising under Regulation D allows shares to be sold to an unlimited number of accredited investors in transactions that are much more widely dispersed than the traditional private placement. Although such securities are initially restricted, they may be resold after a one-year holding period pursuant to Rule 144, provided that certain limited information about the issuer is publicly available. Similarly, as currently proposed, shares issued in crowdfunding transactions would be freely tradable after a one-year holding period.[19]

While there may not be a single, simple solution to this developing problem, it is clear that the Commission needs to take a hard and comprehensive look at Exchange Act Rule 15c2-11, which describes the information required under Rule 144 for non-reporting companies, and provides the conditions pursuant to which broker-dealers may publish quotations in over-the-counter securities.[20] The problems with Rule 15c2-11 have long been documented,[21] and the likelihood of an exponential growth in companies whose securities trade in reliance on that rule is real. The Commission needs to get in front of the problem and not wait until investors are harmed. It is my hope that the staff will complete such a review, together with any recommended ameliorative steps, before the adoption of the rules implementing crowdfunding and Regulation A-plus.

As always, the Commission's focus must be on the public interest and the interests of investors, who alone supply the capital required for capital formation.

I look forward to comments on today's proposal and on the issues raised in the release.

Finally, I want to thank the staff for their hard work on this proposal.

[1] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (the "JOBS Act"), §§ 401-402.

[2] Title IV of the JOBS Act amends certain provisions of the Securities Act of 1933, 15 U.S.C. 77c(b) (the "Securities Act"), to provide this mandate.

[3] The JOBS Act was signed into law on April 5, 2012. Titles I, V, and VI of the Act are self-operating. Rules to implement Title II of the JOBS Act, which amended Rule 506 of Regulation to remove the ban on general solicitation and general advertising, so long as sales are made only to accredited investors, were proposed August 29, 2012 (Rel. No. 33-9354) and adopted July 10, 2013 (Rel. No. 33-9415). Rules to implement Title III of the JOBS Act, to provide an exemption for qualifying Internet crowdfunding transactions, were proposed on October 23, 2012 (Rel. No. 33-9470). In addition, the staff of the Commission published two reports required by the JOBS Act—the "Report on Authority to Enforce Exchange Act Rule 12g5-1 and Subsection (b)(3)" as required by Section 504 of the JOBS Act (October 16, 2012), and the "Report to Congress on Decimalization" as required by Section 106 of the JOBS Act (July 20, 2012)—and hosted a public roundtable on decimalization on February 5, 2013. I have publicly and privately urged the Commission to complete its important work under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), with all deliberate speed. Numerous important requirements under the Dodd-Frank Act remain unfulfilled, despite the fact that well over three

years have passed since enactment.

[4] *See*, Regulation A under the Securities Act, 17 C.F.R. §§ 251-263.

[5] The proposed amendments would provide for the filing of an annual report on proposed new Form 1-K, semiannual updates on Form 1-SA, and current event reporting on Form 1-U, so long as the securities are held of record by at least 300 investors.

[6] Recently-established, fast-growing firms, sometimes called "gazelles," are extremely important to job growth. One study reported that 43,000 rapidly-expanding businesses between three and five years old—about eight-tenths of 1% of all U.S. businesses—were responsible for about 10% of overall net job creation in the economy. D. Stangler, *High-Growth Firms and the Future of the American Economy,* Ewing Marion Kauffman Foundation, Research Series (March 2010) 7, *available at* http://www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2010/04/highgrowthfirmsstudy.pdf Research shows that companies in that category are particularly dependent on outside equity investments for early stage capital. A.M. Robb and D.T. Robinson, *The Capital Structure Decisions of New Firms,* Ewing Marion Kauffman Foundation, (November 2008), *available at* http://www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2008/11/capital_structure_decisions_new_firms.pdf

[7] JOBS Act §401(b).

[8] Securities Act §18(b)(4)(D)(ii), as added by JOBS Act §401(b).

[9] *Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act,* SEC Release No. 33-XXXX (December 18, 2013) ("Proposing Release") 183.

[10] Proposing Release 176-77.

[11] *See,* NASAA Release, dated October 30, 2013, Notice of Request for Public Comment: Proposed Coordinated Review Program for Section 3(b)(2) Offerings, *available at*: http://www.nasaa.org/27427/notice-request-public-comment-proposed-coordinated-review-program-section-3b2-offerings/ ; *see, also,* letter from Andrea Seidt, the President of NASAA, to Chair White of the SEC, dated December 12, 2013.

[12] Proposing Release 185.

[13] Proposing Release 185-88, 192-93.

[14] Proposing Release 185-86 ("We will also consult with the states and consider any changes to the states' processes and requirements for reviewing offerings, before we adopt final amendments.").

[15] Section 19(d) of the Securities Act establishes a policy of federal and state cooperation in securities matters and authorizes the Commission to cooperate with state securities administrators and any association of their duly constituted representatives. For three decades, the Commission and NASAA have conducted an annual conference to promote effective regulation, uniformity in federal and state regulatory standards, capital formation, and administrative efficiency.

[16] In 2012, NASAA members initiated 2,496 enforcement actions, resulting in $694 million in awards to investors and 1,361 years of incarceration sentenced upon violators. NASAA Enforcement Report (October 2013), *available at* http://www.nasaa.org/wp-content/uploads/2013/10/2013-Enforcement-Report-on-2012-data.pdf .

[17] All states currently conduct disclosure review of Regulation A securities offerings, and a majority of the states also conduct merit reviews, based on the terms of the offering. *See, e.g.,* U.S. Gov't Accountability Office, Factors That May Affect Trends In Regulation A Offerings (July 2012) 13.

[18] Securities Act §3(b)((2)(C), as added by JOBS Act §401(a). *See*, Rule 144 under the Securities Act.

[19] The effect is compounded by other provisions of the JOBS Act, which substantially raised the number of holders a company may have before it is required to register as a reporting company under the Exchange Act. This loosening of the reporting threshold is exacerbated by the fact that reporting triggers continue to be based on the number of "record holders," which may fail to count large numbers of beneficial owners for securities held in "street name."

[20] Exchange Act Rule 15c2-11 requires, among other things, that a broker-dealer have in its records certain information specified in paragraph (a) of the rule before it publishes any quotation for an issuer's security in any quotation medium other than a national securities exchange. In addition, the broker-dealer must, based on a review of that information together with any other documents and information required by subsection (b) of the rule, have a reasonable basis under the circumstances for believing that the paragraph (a) information is accurate in all material respects, and that the sources of the paragraph (a) information are reliable. Certain information required by paragraph (a) must be made reasonably available upon request to any person expressing an interest in a proposed transaction in the security with such broker-dealer. However, under the so-called piggyback exception of Rule 15c2-11(f)(3), a broker-dealer may publish quotations on a security in an interdealer quotation system, without complying with such information gathering requirements, if the security has been quoted in the same system on at least 12 of the previous 30 calendar days, with no more than four business days in succession without a quotation. A broker-dealer can "piggyback" on either its own or other broker-dealers' previously published quotations.

17 C.F.R. §240.15c2-11.

[21] *See, Publication or Submission of Quotations Without Specified Information,* SEC Release No. 34-41110 (February 25, 1999), *available at* http://www.sec.gov/rules/proposed/34-41110.htm (reproposing amendments to Rule 15c2-11 originally proposed in response to "concerns about increased incidents of fraud and manipulation in over-the-counter (OTC) securities…"); *Publication or Submission of Quotations Without Specified Information,* SEC Release No. 34-39670 (February 17, 1998), *available at* http://www.sec.gov/rules/proposed/34-39670.txt (the requirement to make information available to investors on request "may have little practical effect because only the first broker-dealer to publish quotations must have the information, and an investor might find it difficult to identify that broker-dealer"); *See, also,* Michael Molitor, *Will More Sunlight Fade the Pink Sheets? Increasing Public Information About Non-Reporting Issuers with Quoted Securities*, 39 Ind. L. Rev. 309 (2006) (due to Rule 15c2-11's "piggyback" provision "it may be difficult for an investor actually to get the information [required by paragraph (a)]." And, Rule 15c2-11 "is badly flawed because neither the investor nor the registered representative of the broker-dealer will possess the required information in most instances. Moreover, even if the piggyback exception does not apply, the investor will receive the information only if he or she asks for it." Also, "[j]ust as the content of paragraph (a) information is paltry compared to the information required of Exchange Act reporters, its timeliness could lag far behind that required of Exchange Act reporters ….").

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