“Spurring Job Growth through Capital Formation While Protecting Investors”
Committee on Banking, Housing and Urban Affairs
U.S. Senate
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Statement for the Record of Barbara Roper, Director of Investor Protection
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As Chairman Johnson so aptly noted in his opening statement at this hearing, “Our nation is facing an unemployment crisis. Nearly 14 million Americans are unable to find a job, and over 5 million have been unemployed for six months or longer.” These Americans deserve serious proposals to put the nation back to work, not poorly thought out legislative experiments that are at least as likely to increase the cost of capital for American companies as they are to promote sustainable job growth. Unfortunately, most of the proposals under consideration in this hearing fall into the latter category; even the best of the proposals are unlikely to result in meaningful job creation.

The bulk of the small company “capital formation” proposals are founded on a series of false premises. For example:

- Advocates of these proposals routinely highlight the fact that small companies disproportionately create jobs. But they conveniently overlook the fact that small companies also disproportionately destroy jobs. Proposals that indiscriminately encourage small company capital formation, without regard to the company in question’s ability to grow and prosper, risk diverting capital from more sustainable enterprises, with a net negative effect on overall job growth.

- Advocates frequently highlight the fact that roughly 92 percent of job growth occurs after a company goes public. And yet they propose to dismantle precisely those characteristics of the public markets that make them such successful venues for capital formation – the ready availability of reliable information on which to make investment decisions, the existence of a liquid secondary market for shares, and robust protections against practices that advantage insiders at the expense of other shareowners, to name just a few.

[1] Consumer Federation of America (CFA) is a non-profit association of approximately 280 national, state and local pro-consumer organizations. It was founded in 1968 to advance the consumer interest through research, advocacy and education.

- In crafting their proposals, advocates tend to focus exclusively on the compliance costs associated with becoming a registered public company and ignore the substantial benefits that flow from the accompanying regulations. It is not a coincidence that American public companies have enjoyed the lowest cost of capital in the world. They do so precisely because the risk premium imposed for investing in transparent, well regulated markets is lower. If an increase in fraud or even non-fraud-related investor losses results from proposals to diminish transparency and weaken investor protections, investors can be expected to demand an increase in the risk premium that at least equals and may well exceed any reduction in compliance costs, negating any job promoting benefits.

- Finally, advocates of these proposals have chosen to blame recent investor protection regulations rather than acknowledge the major changes in the market that have made small company IPOs less attractive than they were in the early years of the 1990s. But the institutionalization of the market that has occurred since that time has fundamentally changed the options for emerging companies seeking to raise capital, making a public offering (or at least an early stage public offering) less necessary. At the same time, the economics of the brokerage industry have changed radically – as a result of such factors as decimalization, electronic trading, and the emergence of alternative trading venues – making it unlikely that the extensive support that once existed for smaller IPOs can be recreated in today's markets.

In basing their proposals on false assumptions, supporters of these measures don't just incur the risk that their legislative proposals will be ineffective in promoting job growth. A side-effect of the increased risk to investors and reduced transparency is all too likely to be an increase in the cost of capital for American companies, particularly the smaller companies these proposals are intended to benefit, with a corresponding negative effect on capital formation and job growth. A further risk is that advocates of this deregulatory agenda will take any such failure to promote job growth not as evidence that their basic premise was misguided, but rather as an invitation to a further round of regulatory weakening, with the predictable result that fraud and investor losses will rise and that the cost of capital will rise along with them.

While most share a common set of largely false assumptions, the specific proposals under consideration in this hearing vary greatly in their approach and in the degree of risk they pose to investors and to market integrity.

Regulation A Revisions
(S. 1544, "The Small Company Capital Formation Act of 2011")

While we do not support this bill in its current form, we do recognize that it is among the more thoughtful of the capital formation legislative proposals under consideration. In particular, its sponsors deserve credit for recognizing that there are benefits to providing investor protections along with the expanded Regulation A exemption, in the form of up-front disclosure, periodic reporting, audited financial statements, Securities and Exchange Commission (SEC) oversight, and a negligence-based litigation remedy. We are concerned, however, that the bill imposes no cumulative limit on use of the Regulation A exemption in multiple years and gives the SEC unlimited authority to increase the ceiling for Regulation A offerings. The latter is of particular concern because, in our view, the bill is unlikely to result in a dramatic increase in use of the exemption given the availability of more attractive options for raising capital either under Regulation D or from venture capital firms. If the bill fails to dramatically increase use of Regulation A, past experience has taught us that that is likely to be seen as a reason to raise the ceiling even further rather than to reexamine the assumptions underlying the approach. Absent a reckless expansion of this sort, however, and with the additional changes we have suggested, we believe the bill is relatively unlikely to do any serious harm and could possibly offer an attractive option for some small companies.

Crowdfunding

(S. 1791, "Democratizing Access to Capital Act of 2011," and S. 1970, "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011")

The purpose of these bills is to create an Internet-based mechanism to allow start-up companies to raise relatively small amounts of seed money (up to $1 million in a 12-month period) from a dispersed group of small investors. The companies that take advantage of this option are likely to be those who are either not yet ready or have failed to attract backing from other sources, such as angel investors or venture capital firms. As a result, the start-up companies that rely on crowdfunding are likely to be among the riskiest, most speculative investments an investor could make.

For these reasons, we would expect to see very high losses for crowdfunding investors, even if appropriate steps are taken to ensure that crowdfunding sites do not become a mecca for fraud. In the 1980s, for example, it was estimated that investors had a 7 in 10 chance of losing some or all of their money in penny stocks simply because of the highly speculative nature of these investments. This risk of losses in penny stocks rose to 9 in 10 when the risk of fraud was included. Ultimately, Congress stepped in and adopted legislation to strengthen investor protections. But penny stocks were, if anything, less inherently speculative and better regulated than the kinds of companies that would take advantage of a crowdfunding options. Failing to learn the lessons of the past, the various crowdfunding bills that have been proposed would permit these highly speculative companies, and the con artists who would inevitably be attracted to the market, to hype their companies on the Internet and raise money from an unlimited number of investors with, under all the various bills except S. 1970, minimal if any regulatory oversight.

We appreciate the steps that Senate sponsors have taken to redress the most serious flaws in the House bill. Even S. 1791, while it falls well short of what is needed to prevent crowd-funding from becoming a haven for fraud, offers significant improvements over its House companion. In particular, it reduces the ceiling on individual investments from $10,000 per offering to a far more appropriate $1,000; it requires, rather than simply permits, use of an intermediary; and it subjects those intermediaries to a more robust set of regulatory requirements. While this is a step in the right direction, only S. 1970 includes a set of investor protections commensurate with the risks in crowdfunding. Among the most important of these are:

- the individual aggregate cap, which would help to ensure, in a way neither of the other bills does, that no individual could lose everything betting on these speculative investments;

- its requirement that crowdfunding intermediaries be registered with the SEC either as a broker-dealer or as a "funding portal" and subject to inspection and appropriate regulatory oversight;

- its more robust requirements with regard to the duties of the intermediary, which include a duty to monitor and enforce the aggregate individual investment limit, limits on conflicts of interest, and SEC authority to prescribe measures to reduce the risk of fraud;

- its prohibition on active solicitation by any crowdfunding site that is not registered as a broker-dealer; and

- its preservation of state authority.

We frankly question the wisdom of the crowdfunding proposals as a general matter. No one has yet explained to us why it is good public policy to allow even the most unsophisticated individuals to put substantial funds at risk investing in the most speculative of companies. S. 1970 at least offers some assurance that this effort would not simply recreate the boiler rooms of an earlier era in a riskier high-tech form. Without that assurance, there is every reason to believe crowdfunding will become a haven for fraud, where unsophisticated investors are hoodwinked out of their limited savings, and no new jobs are produced. Even with the necessary protections incorporated in S. 1970, we see very little reason to believe this will contribute in any meaningful fashion to overall job growth. As with penny stocks in the 1980s, the money lost is likely to greatly exceed the money that is successfully invested in sustainable enterprises, with no appreciable benefits in terms of job growth and significant damage to investor confidence in the integrity of our capital markets.

Shareholder of Record Requirements
(S. 1824, "Private Company Flexibility and Growth Act")

This bill makes it easier for even very large companies to avoid providing the periodic disclosures on which transparent markets depend. It does this by simultaneously raising the limit on the number of shareholders of record who can hold a stock without triggering reporting requirements from 500 to 2,000 and exempting employees who hold company stock from the count. In addition, it would allow banks and bank holding companies to "go dark" if the number of shareholders of record dropped below 1,200. Moreover, it does all this without addressing the outdated and easily manipulated reliance on "shareholders of record" in making this determination. While we question the benefits of a proposal that is designed to reduce market transparency and reduce the incentives companies have to go public, the very least Congress should do if it feels compelled to adopt such a policy is to use a measure that is less subject to manipulation and less likely to permit even very large companies with large numbers of investors to evade basic reporting requirements.

<u>IPO On-Ramp</u>
(S. 1933, "Reopening American Capital Markets to Emerging Growth Companies Act of 2011")

In some ways, this is the most cynical of the "capital formation" bills, because it offers the false promise that delaying compliance with a few investor protection and corporate governance requirements for a new class of "emerging growth" companies can magically restore the more IPO-friendly conditions that prevailed in the markets in the early 1990s and encourage more companies to go public. (Does anyone seriously believe, for example, that the requirement that public companies have a "say on pay" vote every three years is a serious impediment to capital formation?) Moreover, the bill extends its "on-ramp" even to very large companies that could easily afford the cost of compliance. And it attacks, not just existing investor protections, but the independent accounting and audit standard-setting processes.

As we discussed above, the real causes of the drop-off in IPOs can be traced to such factors as the institutionalization of the capital markets, changes that made Rule 144A offerings more attractive to small companies and institutional investors alike, and changes to the economics of the brokerage industry that made these firms less willing and able to offer extensive analyst coverage to or to otherwise support small company IPOs. Since it doesn't address these issues in any meaningful way, there is no reason to believe S. 1933 will measurably change the considerations companies make when deciding to go public. On the other hand, it will measurably reduce investor protections adopted in the wake of episodes of widespread and very damaging fraud.

The bill's "on-ramp," which gives companies that go public five years to come into compliance with a number of the requirements of being a public company, perpetuates a dangerous trend that has emerged in recent years of enabling companies to go public before they are prepared to comply with the basic standards that go with raising money from average, unsophisticated investors. Indeed, this bill validates a prediction we made when it was first suggested that small companies be given a special exemption from SOX 404 – that once policymakers started down the road of creating small-company carve-outs from the requirements for public companies, there'd be no end to their appetite for new and more expansive small company exemptions. As this bill makes clear, there need be no evidence that the carve-outs are necessary or justified or would have a significant impact on capital formation. The ultimate and inevitable conclusion of this approach is the creation of a small company ghetto in the capital markets that investors will learn to shun because of the risks they face there.

It is particularly troubling that this bill continues to scapegoat SOX 404(b) for a drop-off in small company IPOs that cannot in good conscience be laid at its door. If SOX 404(b) were a determining factor, we would have expected to see a further drop-off in IPOs once the requirement was implemented. But charts showing U.S. IPO statistics pre- and post-SOX clearly show that IPOs were rebounding before the 2008 financial crisis disrupted the market. By the same token, if SOX 404(b) were a significant factor affecting small company IPOs, we would have expected to see a significant up-tick in such IPOs once the small company exemption was made permanent more than a year ago. But no such surge has occurred. In short, there is simply no evidence that SOX 404(b) significantly inhibits IPOs, or that allowing companies to delay implementation will lead to an increase in IPOs.[2]

The bill's backers seem to forget that SOX 404(b) was adopted in response to widespread fraud. We know, moreover, that the requirement to have effective internal controls over financial reporting, which had been on the books since the 1970s, was simply ignored until SOX added the requirement for an outside audit of those controls. Similarly, research since SOX was adopted has shown that management's attestation regarding internal controls is more likely to ignore existing weaknesses absent that independent evaluation. There is no reason to believe that "emerging growth" companies would be immune from these problems of lax compliance.

Indeed, by delaying implementation of SOX 404(b), the bill would give companies with up to $1 billion in gross revenues up to a full five years in which to raise money from the public without appropriate protections in place to prevent earnings management and other accounting irregularities. It is true, of course, that companies that engage in earnings management tend to hire, and even to over-hire, in the short term.[3] But they then shed those jobs – and, often, many others – very quickly when the fraud comes to light. In fact, research has shown that the public companies that had to restate their earnings in 2000 and 2001 subsequently lost between 250,000 and 600,000 jobs.

The sponsors of this bill ignore extensive evidence that argues against this approach. Research has shown, for example, that the cost of compliance has come down significantly in the 10 years since SOX was adopted, that compliance with 404(b) improves the quality of financial reporting, and that, as a result, 404-compliant companies enjoy a lower cost of capital than non-compliant companies. Ironically, the bill would perpetuate for all new companies one of the key factors contributing to the initial high cost of implementing SOX 404(b): the cost of retrofitting controls onto established system. Because it simultaneously exaggerates the benefits that would flow from delaying implementation of SOX 404 and ignores the potential costs, the legislation adopts an approach that is at least as likely to inhibit job growth as it is to spur it. Worse, experience tells us that, when this bill fails to deliver the promised up-surge in IPOs, its backers will be back with further proposals to spur growth by undermining investor and market protections.

Conclusion

One of the things that is discouraging about these bills is the degree to which they reflect our policymakers' apparent inability or unwillingness to learn from the past. The Internet bubble and bust, the analyst scandals, the accounting scandals, and the recent financial crisis all had a devastating impact on our markets. All seriously inhibited capital formation and job growth, with particularly severe and lingering effects in the case of the most recent financial crisis. And

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[2] Some have suggested that SOX 404(b) is often cited by foreign companies that decide against listing in U.S. markets. But these companies are unlikely to acknowledge other factors, such as the limits that exist here on siphoning off IPO proceeds to enrich a few insiders and on affiliated transactions on terms that disadvantage general shareholders. SOX 404(b) is a convenient scapegoat for companies whose real goal is to avoid far more basic investor protections that come with a U.S. listing.

[3] Kedia, Simi and Philippon, Thomas, "The Economics of Fraudulent Accounting" (January 2005). AFA 2006 Boston Meetings Paper. Available at SSRN: http://ssrn.com/abstract=687225

each in its own way was the direct result of fatal weaknesses in financial regulations designed to protect investors, promote transparency, and ensure the integrity and stability of our financial markets. By ignoring the lessons of those events, the majority of these so-called "capital formation" bills offer at best gimmicky solutions to a serious problem and at worst offer "solutions" that will actually make the problem worse. It is a cruel and cynical tactic to exploit the jobs crisis to ram through special-interest deregulatory proposals that, in the long run, could trigger even more financial bad news and even more lost jobs. The millions of out-of-work Americans who are victims of our last experiment with financial deregulation deserve better.