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September 8, 2016

The Honorable Paul Ryan
Speaker
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Nancy Pelosi
Minority Leader
U.S. House of Representatives
Washington, D.C. 20515

Vote NO on H.R. 2357, the "Accelerating Access to Capital Act"

Dear Speaker Ryan, Minority Leader Pelosi, and Members of the House of Representatives:

This week the House is scheduled to vote on legislation – H.R. 2357, the "Accelerating Access to Capital Act" – that would weaken the regulatory requirements for public and private offerings of early stage start-up companies. The bill is based on the unproven and illogical premise that we can promote healthy, sustainable capital formation by stripping away protections from the providers of capital. Each of its three major sections would have the effect of reducing the transparency essential to healthy capital markets and weakening the regulatory oversight needed to maintain the integrity of these markets, increasing the risk of fraud and market manipulation. As such, the bill would not only place investors at risk, it would also undermine the very capital formation process it claims to promote.

We are therefore writing on behalf of the Consumer Federation of America, Americans for Financial Reform, and the AFL-CIO to urge you to **VOTE NO on H.R. 2357**.

- **Title I would make it easier for micro-cap companies to raise additional capital without appropriate regulatory scrutiny, increasing the risk of fraud and market manipulation.**

The "shelf registration" system was designed to enable well known, seasoned companies to access the markets more quickly, without undergoing prior review of their offering documents by the staff of the Securities and Exchange Commission (SEC). In 2007, SEC extended the privilege of shelf registration to the smallest public companies, those with a public float of less than $75 million, if they met three conditions associated with reduced risk of fraud: 1) the company's shares are traded on a national exchange, 2) the company is not a shell company, and 3) it has not issued common equity in reliance on the exception in excess of one-third of the value of its public float in the preceding year. This bill would permit any exchange-listed

company, regardless of size, to issue an unlimited number of shares in a given year using shelf registration. Worse, it would allow non-exchange-listed companies (e.g., those sold in the "pink sheets") to sell up to one-third of the aggregate market value of their common equity using shelf registration.

While speedy access to markets enables companies to take advantage of favorable market conditions, it also facilitates several varieties of fraudulent and abusive conduct. These include accounting fraud, market manipulation, and insider trading, all of which have been found to be more common among micro-cap companies and particularly among non-exchange-listed companies. For example, a 2006 study of SEC enforcement actions found that 80 percent of manipulation cases involved non-exchange-traded stocks.[1] A more recent study has found that over-the-counter (OTC) stocks are less liquid and more volatile than exchange-traded stocks, making them more prone to manipulation.[2] It was in light of these concerns that the Commission adopted its current requirements, requirements that would be stripped away by this bill.

As University of Mississippi MDLA Distinguished Lecturer and Professor of Law Mercer Bullard noted in testimony before the House Capital Markets Subcommittee, "The current shelf offering rules reflect careful analysis of the costs and benefits of allowing micro-cap issuers to access public markets with virtually no opportunity for market review."[3] We agree with Professor Bullard that, "Non-exchange-traded micro-cap securities already provide market manipulators with the perfect petri dish of infrequent trading, low trading volume, high volatility, usually negative performance, extreme performance swings, and penny stock prices. The Access Act will further enrich the micro-cap market as a breeding ground for market manipulation and thereby unfairly inhibit capital formation for currently shelf-eligible micro-cap companies and inflict significant losses on unsuspecting investors."

By increasing the risks of market manipulation and fraud, the bill would decrease rather than increase investor willingness to invest in micro-cap offerings and would thus undermine the flow of capital to legitimate micro-cap companies.

- **Title II would create an unnecessary new exemption for private micro-cap offerings that is devoid of investor protections.**

Early stage start-up companies that wish to raise capital in the private markets have a variety of options. These include intra-state or multi-state crowdfunding, a tier 1 or tier 2 offering under Regulation A, or one of the various options available under Regulation D. Each of these options carries somewhat different regulatory requirements designed to appeal to different types of issuers while providing specifically tailored investor protections. This bill would create yet another private offering exemption, but with no meaningful protections for investors beyond a limit of $500,000 on the value of securities that could be sold in a single year and a limit on the number of individuals who can invest.

The bill doesn't require that investors have the financial sophistication to understand the risks of the offering or the financial wherewithal to withstand potential losses. Nor does it require issuers to notify regulators of the offering, require them to provide even minimal disclosures, impose any limits on the amount individuals can invest, or include any restrictions on secondary

sales. Instead, it requires only that the investor have a "pre-existing relationship" with an officer, director or major shareholder of the issuer, a condition that provides no meaningful protections at all. Although the bill includes a "bad actor" provision, its preemption of state oversight all but ensures that there will be no regulatory resources devoted to enforcing that provision or to otherwise preventing fraudulent and abusive practices.

Given the absence of even the most modest investor protections, here is no reason to believe that the bill would be effective in attracting new capital for small private offerings. Instead, the exemption's only "utility" would be as an avenue for highly questionable offerings to avoid regulatory scrutiny, with the predictable result that countless retail investors would suffer devastating losses.

- **Title III would prevent the SEC from taking even modest steps to promote transparency and increase compliance with existing rules for private offerings.**

When Congress removed the ban on general solicitation in private offerings under Rule 506 of Regulation D, it both increased the risk of fraud in a market already plagued by misconduct and eliminated the primary red flag regulators had relied on to identify possibly fraudulent offerings. When the Commission adopted rules lifting the solicitation ban, it simultaneously proposed a modest set of reforms designed to both improve compliance with the rules and provide regulators with better information about this large, important and often opaque market. These proposals were based on recommendations from investor advocates and state securities regulators, as well as the unanimous recommendation of the SEC's Investor Advisory Committee. This legislation would prevent the Commission from adopting these modest reforms even where it finds the actions are necessary to protect investors, to promote market integrity, and encourage capital formation.

Issuers who raise money in reliance on Regulation D are required to file a simple disclosure document, Form D. These filings are necessary both to provide regulators with basic information on the market and to alert them to potentially problematic offerings. But evidence suggests widespread non-compliance with the filing requirements, and the filings themselves lack information necessary to a deeper understanding of the market. The legislation would prevent the Commission from stiffening penalties for failure to file Form D, a step that is crucial to increasing compliance. Failure to file is also a red flag of a potentially fraudulent offering, but the legislation would prevent the SEC from requiring Form D to be filed in advance of any general solicitation, limiting its ability to prevent fraud before extensive damage occurs.

Although the Reg D market rivals the public markets in size and importance, the Commission lacks even the most basic information about the success of these offerings in raising capital and promoting sustainable job growth. The Commission has proposed to require an additional filing at the termination of the offering containing information on the total amount of capital raised. This would promote market transparency and informed policy making. The legislation would prevent the Commission from adopting this requirement. In addition, the legislation would prevent the Commission from requiring private funds, which are now free to advertise, to follow guidelines designed to ensure their advertisements are not misleading.

In short, the legislation would prevent the SEC from taking appropriate actions to provide needed oversight of the Reg D market, would perpetuate widespread non-compliance with the existing filing requirements, and would undermine informed policymaking.

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Policymakers who want to promote healthy, sustainable capital formation need to think seriously about how to attract capital to the small company market. This bill goes in the opposite direction. By increasing risks to investors without offering any off-setting benefits, the bill would undermine capital formation and further erode the foundation upon which our capital markets' success has been built. We urge you to vote no when H.R. 2357 is brought to the House floor for a vote.

Respectfully submitted,

Barbara Roper, Director of Investor Protection
Consumer Federation of America

Lisa Donner, Executive Director
Americans for Financial Reform

Heather L. Slavkin Corzo, Director of the Office of Investment
AFL-CIO

Endnotes:

[1] Rajesh Aggarwal and Guojon Wu, *Stock Market Manipulations*, 79 Journal of Business 1915, 1935 (2006). This total includes 29.58 percent of cases involving stocks for which market information was unavailable (which therefore presumably were not traded on a national securities exchange).

[2] See Ulf Brüggemann, Aditya Kaul, Christian Leuz, and Ingrid M. Werner, *The Twilight Zone: OTC Regulatory Regimes and Market Quality*, Fisher College of Business Working Paper No. 2013-03-09 (August 1, 2013) available at ssrn.com/abstract=2290492.

[3] Testimony of Mercer E. Bullard, President and Founder, Fund Democracy, Inc. and MDLA Distinguished Lecturer and Professor of Law, University of Mississippi School of Law, on *Legislative Proposals to Enhance Capital Formation and Reduce Regulatory Burdens, Part II,* before the Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives (May 13, 2015) available at http://financialservices.house.gov/uploadedfiles/hhrg-114-ba16-wstate-mbullard-20150513.pdf.