Consumer Federation of America

May 5, 2014

The Honorable Jeb Hensarling
Chairman
Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters
Ranking Member
Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Hensarling, Ranking Member Waters and Members of the Committee:

I am writing on behalf of the Consumer Federation of America to express our strong opposition to a number of the bills scheduled for mark-up in the Financial Services Committee this week. Each of these bills to varying degrees further erodes important aspects of the securities laws that have helped to foster the transparency and investor protection that long made our markets the envy of the world. As a package they continue a dangerous trend in this Committee of examining capital formation issues exclusively through the eyes of issuers, ignoring the concerns of the investors we rely on to provide the capital that enables American businesses to grow and prosper.

As Washington Securities Division Director William Beatty said in recent testimony before the Capital Markets Subcommittee, "Investor confidence in our system is what fuels economic growth and job creation."[1] But investor confidence in the integrity and stability our markets is at a dangerously low level.[2] That lack of confidence in the markets contributed to the lowest level of stock ownership among American adults in 2013 in 25 years.[3] Nothing Congress does to lower the regulatory costs of issuers will succeed in fueling the economy if the providers of capital, battered by repeated scandals and crises, continue to stay on the sidelines. And if, in its zeal to lower issuers' regulatory costs, Congress weakens market oversight, reduces transparency, and exposes average unsophisticated investors to greater risks, as these bills would do, it will contribute to a downward spiral in investor confidence that could have devastating consequences for both the retirement preparedness of our nation's citizens and the health of our economy.

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[1] Written Testimony of William Beatty, Washington Securities Division Director and President-Elect of the North American Securities Administrators Association, Inc. before the House Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises, on "Legislative Proposals to Enhance Capital Formation for Small and Emerging Growth Companies, Part II," May 1, 2014.
[2] See, for example, the Chicago Booth/Kellogg School Financial Trust Index for 2013, which put public trust in the stock markets at just 15 percent.
[3] Saad, Lydia, "U.S. Stock Ownership Stays at Record Low," Gallup, May 8, 2013.

In order to ensure that our markets continue to be a place where investors can save for long-term financial goals and companies of all sizes can raise capital and grow, we urge you to vote no against the following bills.

1) **Vote NO on H.R. 4554, the "Restricted Securities Relief Act."**

This legislation would make it easier for large, sophisticated investors to profit at the expense of average individual investors, reinforcing the view that the markets are rigged against the little guy. It would do this through the seemingly innocuous step of reducing from six months to three months the mandatory holding period before the accredited investors and qualified institutional buyers who purchase restricted securities issued by an SEC reporting company could resell them to the public. Mandatory holding periods are designed to ensure that purchasers of restricted securities buy the securities as an investment rather than simply to act as distributors of those securities. A three-month holding period simply does not provide that protection. Meanwhile, there is no evidence that the current six-month holding period is inhibiting investment in these securities. Thus, legislation that encourages quicker resale of the securities will do nothing to promote sustainable capital formation.

While the legislation is unlikely to have any beneficial effect on capital formation, it is highly likely to further undermine investor faith in the integrity of the markets. As both Mr. Beatty and Columbia Law School Professor John Coffee[4] noted in their testimony before this Committee, reducing the holding period for restricted securities to just three months would enable more sophisticated accredited and institutional investors to use their access to private offerings to purchase the shares at a discount and then dump the shares in the public markets on average, unsophisticated investors. Such resales do not produce additional capital for the issuer and could, in fact, destabilize their funding support. We share the concern expressed by Mr. Beatty that, if the legislation is adopted, it will "flood the market with Rule 506 offerings that are unloaded by large sophisticated investors on less sophisticated 'mom and pop' investors. Because these are resale transactions, if the business fails or becomes insolvent, the business will have already received the initial money from the large investors, those investors will have received a quick profit, and the retail investors will be left holding worthless shares." For these reasons, we urge you to vote no.

2) **Vote NO on the "Small Business Freedom to Grow Act."**

This legislation would permit virtually any company that is not a shell company to use shelf registration and issue securities without providing advance notice or updating its prospectus. The shelf registration system was designed for seasoned companies that are constantly in the markets and where the level of media and analyst coverage helps to ensure that they generally trade in an efficient market. The small companies permitted to use shelf registration under this bill, including companies that trade in the Pink Sheets or on the OTC Bulletin Board, have none of those characteristics. As such, they simply are not suitable

[4] Statement of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School, before the Subcommittee on Capital Markets and Government Sponsored Entities, Committee on Financial Services, U.S. House of Representatives, regarding "Legislative Proposals to Enhance Capital Formation for Small and Emerging Growth Companies," April 9, 2014.

candidates for such offerings. The most likely, and perhaps the best outcome, if this legislation is adopted, is that the market simply will not accept such offerings, and thus it will do nothing to promote capital formation. We appreciate that the state preemption provisions have been removed from the latest version of the legislation. The original draft, which simultaneously reduced notice of small company offerings and reduced state oversight, would, as Professor Coffee said, have invited "fraud and misconduct." Indeed, even with the protection of state oversight, this bill increases the risk of fraud and misconduct without offering any benefits to justify that added risk. We therefore urge you to vote no.

3) Vote NO on the "Disclosure Modernization and Simplification Act."

This legislation would require the Securities and Exchange Commission to adopt changes to its disclosure requirements, including disclosures for emerging growth companies and smaller issuers, under a hurried 180-day timeframe without sufficient opportunity for study and analysis of the issue. Indeed, the required changes would precede by six months completion of the bill's mandated study to identify areas of the disclosure regime that may be in need of modernization and improvement. We believe there is room for improvement in the current disclosure regime, but hasty rulemaking that does not flow from a careful analysis of the issue – including in particular the information needs of investors – is likely to do more harm than good. We therefore urge you to vote no.

4) Vote NO on the "Private Placement Improvement Act."

The first official action of the SEC's non-partisan, broadly representative Investor Advisory Committee (IAC) was to adopt unanimously a set of recommendations designed to ensure that investors in private securities offerings under Rule 506 of Regulation D receive adequate and appropriate protections.[5] While we were disappointed that the Commission finalized its rule permitting general solicitation in private offerings without adopting, or even considering, any of the recommended investor protections that had been put forward, the Commission did issue a separate rule proposal incorporating a few of the key protections recommended by the IAC. These include changes designed to ensure the Reg D issuers actually file Form D (something that frequently does not occur today), provide more information about their general solicitation plans, and do so in a way that better enables the SEC and state regulators to monitor activity in a market that now exceeds the public markets in size. Also included was a recommendation designed to prevent misleading marketing practices by private funds.

This legislation is designed to ensure that the Commission cannot collect the information it needs to effectively monitor this market or take other important steps to protect investors. While we are pleased that the legislation has been revised to allow for a Form D filing no later than the date of first sale, this timing fails to provide an adequate opportunity for regulatory review in advance of the offering. Moreover, the legislation still prevents the Commission from imposing even modest consequences for those who fail to comply with Form D filing requirements, all but ensuring that the current lax compliance will continue. And it prevents the

[5] The Committee recommendations are available here: http://www.sec.gov/spotlight/investor-advisory-committee-2012/iac-general-solicitation-advertising-recommendations.pdf.

Commission from collecting the kind of post-offering information that is needed to analyze whether companies are able to use the exemption as an effective capital formation tool. The legislation also seeks to prevent the Commission from providing guidance to private funds on the kinds of marketing practices that would be deemed to be misleading, even though there is a well-documented history of misleading performance claims among private funds.

As Mr. Beatty noted in his testimony on behalf of NASAA, the legislation is "an assault on the authority of the SEC to provide basic, reasonable investor protection." Moreover, by putting these restrictions on Commission authority in statute, the legislation would prevent the Commission from responding quickly and effectively if market developments, such as an upsurge in fraud, warrant further action. Because it would prevent the Commission from effectively monitoring the huge and hugely important Reg D market and taking even modest steps to prevent abuse, we urge you to vote no on this legislation.

5) Vote NO on the legislation to change the definition of well-known seasoned issuer.

This legislation would require the Commission to revise the definition of "well-known, seasoned issuer" (or WKSI) to include issuers that are neither well-known nor seasoned. As Professor Coffee noted, the primary effect of this change would be to make the vast majority of public companies eligible for automatic shelf registration, which permits the sale of securities without any prior review of the registration filing by the Commission. Professor Coffee went on to note that eliminating the opportunity for SEC review of registration filings "both invites misbehavior (if an issuer knows it will not be subject to prior review) and encourages costly litigation (if errors are later discovered)." NASAA raised similar concerns in its testimony. Moreover, because WKSIs can register securities for sale for the account of selling shareholders without separately identifying "the selling security holders or the securities to be sold by such persons" until the time of the actual sale by such persons, expanding the definition will promote secondary sales by large shareholders which do nothing to raise additional capital and create jobs. As noted above, promoting resales and promoting sustainable capital formation are two very different things. Because it would reduce market transparency, weaken regulatory oversight, and do nothing to promote capital formation, we urge you to vote NO on this legislation.

6) Vote NO on the "Startup Capital Modernization Act."

In a carefully worked out bipartisan compromise, the Regulation A provisions in the JOBS Act preserved the authority of states to oversee these small, mostly local offerings unless they are sold on a national exchange or to qualified purchasers. This legislation would eliminate the ability of states to provide that much needed oversight. It fails to acknowledge the remarkable progress states have made in adopting a coordinated review system for Regulation A offerings. And it places inordinate faith in the ability of the Commission to oversee this market without any additional resources forthcoming to enable this enhanced oversight. By undermining regulatory oversight of this market, the legislation would increase the risk of fraud.

The legislation would also allow investors to engage in general solicitation to sell shares in private offerings to other investors, further increasing the risk of fraud in a market that is

already a major source of state enforcement actions. Such sales will do nothing to promote capital formation. Moreover, the requirement that sellers verify the accredited investor status of purchasers poses particular challenges in this context and is unlikely to be effectively enforced. Indeed, because the sales will be conducted by individuals who are not subject to regulation, there would be no way to provide effective regulatory oversight to prevent fraud and abuse. Because the legislation will increase the risk of investor harm without making any meaningful improvements to the capital formation process, we urge you to vote no.

7) Vote NO on the "Equity Crowdfunding Improvement Act."

Title III of the JOBS Act provided for the creation of a new online marketplace where early stage start-up companies can raise small amounts of seed capital from investors who are neither wealthy nor financially sophisticated. Experience tells us that the majority of these early stage companies will fail, leaving their investors with nothing. Even crowdfunding investors who are fortunate enough to get in on the ground floor of a successful company may not profit on that investment if the value of their shares is diluted in future funding rounds. In short, in a market that brings together inexperienced issuers and unsophisticated investors, the potential for bad outcomes is enormous.

In at least partial recognition of those risks, the original JOBS Act included some important investor protections designed to mitigate those risks. Unfortunately, the rules proposed by the SEC to implement the crowdfunding provisions of the JOBS Act are extraordinarily weak. They allow important information, such as risk disclosures, to be provided through a mechanism that doesn't even require delivery of the information to investors. They propose to deter fraud by having issuers check a box indicating that they are in compliance. And they take an approach to setting investment limits that maximizes the risk that crowdfunding investors will suffer unaffordable losses.[6] For these reasons, the rules were roundly criticized by investor advocates, state securities regulators, and even the chief sponsor of the Senate crowdfunding bill. At its most recent meeting, the SEC's Investor Advisory Committee unanimously approved a set of recommendations calling for the rule proposals to be strengthened.[7]

Instead of mitigating the risks in the Commission's lax approach to crowdfunding implementation, this legislation would make them much worse. It would greatly increase the risk that crowdfunding investors would invest based on an insufficient understanding of the risks and suffer unaffordable losses on their crowdfunding investments. The one proposed change in the legislation which we do support – clarifying the right of funding portals to "curate" their offerings without automatically triggering regulation as a broker-dealer – has been raised in the comment process (including in the IAC recommendation) and is likely to be addressed when the rules are finalized.

[6] CFA's detailed comment on the proposed rules is available here: http://www.sec.gov/comments/s7-09-13/s70913-78.pdf.
[7] The IAC crowdfunding recommendation is available here: http://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-adviser-crowdfunding-recommendation.pdf.

Crowdfunding is doomed to failure if the headlines over the next few years highlight painful losses to investors rather than exciting new companies developed. Because it would heighten the risk that crowdfunding proves to be an unmitigated disaster for investors and issuers alike, we urge you to vote no on this legislation and to instead convey the opposite message to the Commission: that it is the expectation of members of Congress that the Commission implement the law in a way that is consistent with the statute and provides the full measure of investor protections intended by Congress when the JOBS Act was enacted.

8) Vote NO on the "Fostering Innovation Act."

This legislation is designed to exempt a broad swath of established public companies from requirements designed to ensure that they have effective procedures in place to prevent accounting fraud and material errors. As such, the only "innovation" it would foster is the "innovative" accounting that has in the past wreaked such havoc in our markets. Moreover, since it applies this regulatory relief to companies that have already gone through the initial expense of coming into compliance with these requirements, it would do little to reduce their regulatory burdens. But past experience tells us that it would significantly reduce the reliability of financial disclosures for the companies that are most likely to experience accounting fraud and errors. Clearly for some rolling back the Sarbanes-Oxley Act requirements that ensure that auditors include an evaluation of fraud controls as part of the financial statement audit has become an end in itself, without regard to the well-documented benefits of the independent assessments or their affordability for public companies of all sizes. Because it is not justified based on the costs of the audits and would reduce the reliability of information investors rely on for the efficient allocation of capital, we urge you to vote no on this legislation.

CFA has not taken a position either for or against H.R. 4200, the SBIC Advisers Relief Act, at this time. In addition, while we oppose the "Encourage Employee Ownership Act" on the grounds that it both exaggerates the burdens imposed by existing disclosure requirements and understates potential risks, we do not believe this bill poses the same direct and extensive threat to market integrity and investor protection as other bills under consideration in this mark-up.

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The JOBS Act enshrined a radical concept, that the best way to promote small company capital formation is to reduce the transparency that promotes market efficiency and to strip away protections for the providers of capital. With much of the legislation not yet implemented, and the rest too new to allow for meaningful evaluation, it is too soon to tell whether the JOBS Act will produce the jobs-promoting benefits promised by its supporters or the wealth-destroying harms predicted by its opponents. It is certainly far too early to double down on an approach that ignores the historic correlation between investor protection, market transparency, and the cost of capital. We therefor urge you to vote no on these reckless, unfounded, and ill-advised bills.

Respectfully submitted,

Barbara Roper
Director of Investor Protection