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U.S. SECURITIES AND EXCHANGE COMMISSION

MEETING OF
SEC ADVISORY COMMITTEE ON
SMALL AND EMERGING COMPANIES

Friday, September 7, 2012
9:00 A.M.

U.S. Securities and Exchange Commission
San Francisco Regional Office
44 Montgomery Street, Suite 2800
San Francisco, California

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PARTICIPANTS:

ADVISORY COMMITTEE MEMBERS:
STEPHEN M. GRAHAM, CO-CHAIR
M. CHRISTINE JACOBS, CO-CHAIR
DAVID A. BOCHNOWSKI
JOHN J. BORER, III
DAN CHACE
MILTON CHANG
JOSEPH (LEROY) DENNIS
SHANNON L. GREENE
RICHARD L. LEZA
KATHLEEN A. McGOWAN
CATHERINE V. MOTT
KARYN SMITH
CHARLIE SUNDLING
TIMOTHY WALSH

SEC PERSONNEL:
KATHLEEN HANLEY
GERALD LAPORTE
LONA NALLENGARA
TED VENUTI
JENNIFER ZEPRALKA

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PARTICIPANTS (CONT.)

PANELISTS:

MORNING SESSION:
JAY RITTER, Ph.D.
DAVID WEILD
EDWARD KIM

AFTERNOON SESSION:
STEVEN E. BOCHNER
JEFF SCHWARTZ
ROBERT BARTLETT

STAFF PRESENTATION:
MARC FAGEL

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P R O C E E D I N G S

(9:00 a.m.)

MR. GRAHAM: Okay. Why don't we get started. First of all, this is a minor administrative matter. Just to make sure the video has feedback through the mic, just make sure that the iPhones, BlackBerrys, etc., are, if not back in your pocket, at least away from the mic.

Is someone taking attendance?

Do we have a quorum?

MR. LAPORTE: Yes, yeah, we have a quorum.

MR. GRAHAM: Okay. Good.

Well, thank you everyone for coming. Once again, I thank the committee members for giving us their time and helping to address the issues that we've been assembled to address. And as always, we appreciate greatly all the work of the SEC staff. I think the thing I appreciate most, based on the West Coast, is we're meeting on the West Coast. This is something I could definitely get used to.

As we all know, the charge of this committee is to do -- to make recommendations to the SEC for changes that will improve access to capital for smaller businesses who -- related to that is of course the compliance cost/benefit, which involve the burden of

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time and capital.

We have made a number of recommendations, as you know, since we've been at this for the past -- I guess about a year.

MS. JACOBS: I think so.

MR. GRAHAM: Okay. And as you know, many of those recommendations showed up in the JOBS Act, and I think we have made -- made some progress down the road of improving access to capital for businesses. But there's -- obviously, there's still a lot of work.

And the next areas we wanted to tackle as a Committee, which was touched on in the last Committee meeting, are the areas of market structure and also the area of compliance.

In terms of market structure, the notion is that there are certain -- when we think about -- when we think about the demise of the small IPO, and try to, you know, understand why this has occurred, certainly we can understand the effects of this having occurred, but to really kind of understand the causes and gain a greater appreciation for perhaps what can be done in order to correct the situation, if you will.

There are obviously differing points of view. There's lots of room for debate. Certainly one of the things that I think we're all aware of, the discussion

around the, you know, so-called tick sizes, that is -- that is -- we're going to spend our time this morning discussing.

And to assist us with that discussion, we have put together an expert panel. And if you don't -- if you bear with me, then I'd just like to read who's speaking.

First of all, Jay Ritter.

Jay, thanks for coming.

Jay is the Joseph Cordell Eminent Scholar in the Department of Finance at the University of Florida. He holds a Ph.D. in Economics and Finance from the University of Chicago and has previously taught at the Wharton School, the University of Michigan, University of Illinois at Urbana-Champaign, and MIT Sloan School of Management. He is known best for his articles on financial issues.

Thank you, Jay.

Dave Weild is probably familiar to most of you. David has written extensively in the area of tick sizes and structural changes that occurred in the market over the last number of years that led to a number of regulations that have perhaps unintended consequences. And he was in our last -- in our last meeting. I think you're familiar with his work. I don't think anybody

knows about this area better than David. You can have a different point of view, but one thing for sure is that David knows his stuff.

He oversees Capital Markets and Institutional Acceptance at Grant Thornton. He's also Chairman and

CEO of Capital Markets Advisory Partners, the firm that specializes in equity capital markets advice to issuers. He is a former Vice Chairman and Executive Committee member of the NASDAQ Stock Market. And prior to NASDAQ, David worked at Prudential Securities in senior management roles.

Thank you again, David, for joining us.

This time, David brought one of his partners, and that is Edward Kim, who is Co-Founder and Managing Director of Capital Markets Advisory Partners and is also a senior member of the Capital Markets group at Grant Thornton. Ed has over 20 years of capital markets, finance, and operations experience.

Again, David and Ed have produced a series of studies that have been influential in the debate over whether the structural and regulatory changes to the stock markets have undermined capital formation in the U.S.

Those will be our speakers this morning. They will impart some of their knowledge to us. And the idea

is that not only will they make presentations, but they will be part of the conversation. And so we would expect members to join in with questions and comments in part of the conversation.

The idea today is that, you know, after we hear from this morning's panel, we will break, and then we'll spend a little bit of time on just kind of a JOBS Act update recap.

We will then break for lunch, and then we will hear from the panel that is going to address compliance and some of the regulatory burdens that the smaller companies face. We will talk about those this afternoon.

After we hear from that panel, we will break and then take time to discuss what we've heard in the process following the recommendations to the SEC in these areas and, you know, anything else that you want to add.

Flipping back, the SEC staff with us today are: Lona Nallengara; Gerry Laporte; Jennifer Zepralka; Kathleen Hanley, and -- who is the Deputy Director and Deputy Chief Economist, Division of Risk, Strategy, and Innovation; and Ted Venuti, who is over in the corner, who is Senior Special Counsel in the division of Trading and Markets.

And again, we thank the staff for all the work that they do to support this Committee, and certainly all the work they do on that basis. For those of us close to the SEC, we understand -- at least we have -- can't say understand, but at least we have some sense of the pressure and the burdens and workload that you guys face, and we thank you for that.

Chris, do you have anything to add?
MS. JACOBS: No. You covered it, I think.
MR. GRAHAM: Without further ado -- Mr. Nallengara, do you have anything?
MR. NALLENGARA: No. Steve, we're going to start with a brief update on -- I'm not sure if we sent with the materials -- the report the SEC staff prepared on decimalization on tick size. Kathleen --
MR. GRAHAM: Can I stop you?
MR. NALLENGARA: Sure.
MR. GRAHAM: I hate to kind of interrupt somebody's flow of thought.
MR. NALLENGARA: Go ahead.
MR. GRAHAM: Apparently the audio feed is not very good for us. And so everyone who is speaking, speak into the mic.
MS. NALLENGARA: Okay. So as I mentioned, we had -- the JOBS Act required that the SEC to do a report
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within 90 days of the enactment of the JOBS Act, which was July 4th, on -- on the effects of tick size and decimalization on IPOs.
So the staff prepared this report. Kathleen led our efforts on that, and that report was posted on our website a few days -- weeks after the deadline, but it is complete, and Kathleen is going to give us a brief update on that.
And we turn it over to you.
MS. HANLEY: Thank you.
So as Lona mentioned, we had 90 days to do a study. We took a three-prong approach to doing the study. The study was mandated to look at the effect of decimalization on IPOs and specifically on small- and mid-cap companies. Given the tight deadline, we concentrated our efforts at looking at the academic literature to begin with. And then we had our roundtable here where David spoke and Professor Harris spoke, and we looked at international tick sizes.
For the most part, the studies that we were able to find talked mostly about the effect of decimalization around the time of decimalization on market quality, things like spreads, depth, and that sort of thing.
We did not find any studies that purported to
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speak to the link between decimalization and capital formation. And I'll return to that in a moment.
For the most part, the effect of decimalization at the time it was enacted appeared to improve market quality for large liquid stocks the most.
We have one study that focused on small and mid cap stocks, but there was no statistically significant change in spreads at the time the decimalization occurred.

I leave it to you to see the rest of the findings.

Overall, market quality improved, particularly for large stocks. Many did not make a distinction between large and small stocks, and where they did, we noted that.

But there are some caveats with using this literature to draw strong conclusions about the effect of tick sizes on capital formation.

First of all, the studies were done around the time of enactment. And of course many, many years have passed since then, and the markets have changed substantially, the market for capital has changed substantially, and these studies could not speak to that.

In addition, the samples, many of these did

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not focus on small companies. And I don't think the concerns were there at the time that the studies were done. They were looking to see market quality issues.

So, you know, we're very cautious about saying that the academic literature should drive us in any direction with respect to what we should be doing or what the Commission should be doing with respect to tick sizes.

We did survey internationally. The U.S. has a one-size-fits-all policy as compared to a number of international venues, such as Hong Kong and Japan and the UK, which have sometimes quite elaborate tick size schemes, to the point where sometimes we had to spend some time to figure out what tick would apply to what type of company. So we are mindful that other regulators and other exchanges have noticed that tick size may be important for smaller companies. Generally tick sizes increased with the -- with the -- with the price, the company went lower.

And so given the discussion, we were mindful that some of the direct linkages between changing tick sizes and capital formation appeared to be not well documented, and we wanted in the study to tee up having a roundtable that would allow us to address a number of questions.

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And I think there are three primary challenges that I think we face when they think about this issue, and I think this group may be well-suited to begin the discussion of these types of challenges.

So the first thing is it's uncertain whether or not increasing the tick size would in fact increase spreads. So that would be the first. Spreads, and obviously when Gregg Berman was here last time, we noted that tick sizes are not spread sizes. They're price movements. And so, therefore, would tick sizes increase spreads? So that's the first thing.

And if they did increase spreads, would that increase market maker profitability, or would investors who benefit from lower transaction costs not transact as frequently in smaller public companies?

So would there be an offsetting effect from investors who now have to pay potentially a larger spread to transact?

Third, if in fact investors did not take that into consideration, it did not have an offsetting effect to the size of spread, would market makers indeed use the extra profits they have on spreads to use that money to aid companies in analyst coverage and other things that capital formation might benefit?

And so we're convening the roundtable sometime

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in the next few months, and we hope that in addition to this we would have some answers to that question.

Also, some guidelines on how to find direct causality between changing tick sizes and capital formation is that it seems to be a road that has a number of different paths that could occur, as well as a number of different circles that, you know, one can travel around to get to that point. There's analyst coverage we're trying to fix. And I'm sure the panelists here will have a nice viewpoint with respect to that. So we're looking forward to having that, whether or not we should do a pilot study, how that pilot study should be conducted.

So we're convening a roundtable, and you should be hearing more about that in the future. If you have any questions about, I'm happy to answer questions about that today.

(No audible response.)

MS. HANLEY: No?

I'll turn it over to Jay.

DR. RITTER: Thank you.

Feel free to interrupt with questions at this time. Feel free to interrupt with questions or comments as we go along here.

My presentation is going to be loosely based

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upon a working paper that I have with two co-authors, Xiaohui Gao and Zhongyan Zhu, both who are educators in the United States, but now teach in Hong Kong, although actually, Xiaohui Gao is visiting at the University of Maryland this year.

And the question that we're addressing here is the question that is of interest to all of us: Where have all the IPOs gone?

I believe at the June meeting Professor Jeff Harris showed this -- this graph or a very similar graph where this shows the annual volume of operating companies in the United States from 1980 to 2011. And what we see here is that from 1980 to 2000 on average

302 companies went public every year -- I'm sorry, 311 companies went public every year in the United States. And in the last 11 years, which I'll call the last decade for convenience, only 99 companies on average have gone public. And this drop-off is even more dramatic if we think about during the last three decades U.S. real GDP has doubled, more than doubled. And so if you think there ought to be the same number of IPOs per trillion dollars of GDP, we ought to see a doubling from the beginning to the end rather than this big drop-off.

And as we're all aware, over the last decade there have been some bear markets, but the market has

recovered, and we haven't seen a recovery in IPO volume to anywhere near the levels of a normal year in the 1990s.

And even more dramatically, this big drop-off has been concentrated among small company IPOs. This graph defines big and small companies, not on the basis of the proceeds raised or the market cap of the offering, but the annual inflation adjusted sales of the company in the year before going public using $50 million as a cutoff, where approximately half of all the companies that have gone public in the last 32 years were below $50 million and half above that.

And what you see, the red lines in back, the red bars give the annual volume of large company IPOs. The blue lines in front give the annual volume of small company IPOs. And before 2000, from 1980 to 2000, a typical year at least as many small companies went public as big companies. Since then, the number of small companies has been dramatically lower. And the drop-off from an average year in the previous couple of decades to this decade has been about 80 percent for the number of small companies going public, you know.

So this is what we're all worried about. A lot of public policy discussions focus on this. The JOBS Act was certainly motivated by part of this

pattern.

And as we can see here as well, even when the stock market was closer to its peaks in 2007, and now there has not been anywhere near the number of small company IPOs as was typical in the 1980s and '90s.

If we look at the age distribution of companies going public, this is each year, the 25th, 50th, and 75th percentile of the age since founding of companies going public, what you see is in the '80s and '90s, most years the median age was about seven or eight years. That dropped a bit during the Internet bubble period. But in the last decade very few young companies have been going public. So whether we focus on sales or the age of companies going public, young small companies just have not been going public this decade.

That doesn't mean that there aren't any young small companies out there. The venture capitalists have poured a lot of money into financing small companies, merging companies in the last decade. There's a big increase in the amount of VC funds committed in '99 and 2000. And if you would think more money being poured into venture capital ought to lead five years later to more IPOs, we would have expected to see more IPOs this decade rather than fewer.

This graph shows from 1990 to 2011 of the

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exits of venture capitalists, so in other words, of their portfolio companies that they're exiting either by a trade sale or by taking the company public.

The green part of the bars are the exits via going public, and the lower black parts are the percentage of exits via having a company acquired, merger and acquisition, a trade sale. And what you can see there is in the 1990s a steady upward trend, and then this decade, very few exits via IPOs, much larger fraction of exits via trade sales.

And one big question is: For the lack of IPOs, is it because the IPO market is broken, or is it because of some other factor that's made trade sales more attractive, or more likely some combination of these things? I don't think there is one simple explanation to describe all of these patterns together.

Well, the conventional wisdom is that the IPO market is broken, and we're all familiar with a lot of the arguments.

The Sarbanes-Oxley Act of 2002 imposed costs on publicly traded companies, especially burdensome for small companies, although some of the burdensome requirements were relaxed in 2007. And the JOBS Act also further relaxes some of these things.

And as David Weild and Ed Kim will be talking

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about decimalization, Regulation FD in 2000, the Global Settlement in 2003, various other things, both from regulation and changes in market practice, have resulted in a drop in analyst coverage, in particular, of small companies. And if we make the assumption that analyst coverage results in more investor interest, a greater willingness of companies to pay -- a greater willingness of investors to pay out a bigger price for your company. The lack of analyst coverage has depressed the prices of publicly traded small companies and, therefore, changed the relevant price in private markets to public markets and made it less attractive for a company to go public.

We call these explanations in our paper the regulatory overreach hypothesis to over-simplify that heavy-handed regulation, and some unintended consequences of some of that regulation has resulted in it being more expensive to be a publicly traded company, and the valuation that a company can get in public markets has decreased to the detriment of capital formation.

Life is full of trade-offs, and, you know, in terms of attempting to protect investors from fraud, possibly some regulatory changes have gone too far. And the benefits of reduced investor fraud have been more than offset by excessive compliance costs, regulatory

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costs, etc.

I'm glad I'm not a regulator who has to get these balances exactly right to trade off investor protection and capital formation. I don't want to pretend that the answers are always easy or how to get the balances right.

MR. WALSH: Professor.

DR. RITTER: Yes.

MR. WALSH: Would you repeat what you said about the benefits?

DR. RITTER: The benefits of compliance and investor protection. One way to think about it is, instead of stocks, what if we're talking about going into a produce store and buying apples? And there's a barrel of apples, a hundred apples in the barrel. And from experience, we know that two of them are probably rotten inside and 98 percent of those apples are going to be nice and tasty.

Well, if we were willing to pay a dollar for a good apple, we would be willing to pay 98 cents for a 98 percent chance that we're going to get a good apple.

Now, if for a penny of compliance cost the store provider or we could screen out all of the bad apples and figure out inside is it a good apple or a bad apple and for a penny get rid of the two bad apples,

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that then there would be 98 good apples in that barrel, and we would be willing to pay a dollar for each of those good apples.

And in this simple example, the one penny in compliance cost is worth more than the two cents in bad apples that we're getting rid of.

On the other hand, if there's compliance cost for 20 cents, I think most of us would be willing to pay for a 2 percent chance of a bad apple rather than paying 20 cents to get rid of a 2 percent chance of a bad apple.

So, you know, depending upon the numbers, maybe it would be worthwhile to screen out the bad apples, maybe it would not be.

And, you know, if we're talking about massive frauds like WorldCom and Enron, compliance costs are reasonable. Certainly some investor protection is worthwhile, but clearly you can overdo it as well.

MR. WALSH: Great analogy.

DR. RITTER: In our paper we're arguing that, while there may be overreaching regulation, we think that an important reason for there being fewer small company IPOs is that there has been a long-term structural change going on, something that did not just happen overnight, but basically getting big fast is more

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important than it used to be, especially for technology companies, that for a variety of reasons increased speed of communications, the half-life of innovation has gotten shorter, speeding a product to market before too long occurs, and the competition has a better product. All of these have been gradually changing over time. And getting big fast is more important than it used to be.

And consequently, for a company to grow slowly organically is in some cases no longer the optimal profit maximizing business strategy. That, instead, getting big fast, possibly by making acquisitions, possibly by getting acquired and allowing a bigger organization to rapidly realize economies of scope.

Economies of scope refer to the concept of related businesses having cost efficiencies or greater revenue potential if you can combine related businesses.

Classic example is if you're selling ice cream and refrigerated milk. Well, two separate companies could have a truck going from grocery store to grocery store delivering milk and another truck delivering ice cream, but there are obvious efficiencies in the distribution if you have one truck delivering both ice cream and milk to the grocery stores. That would be an example of economies of scope.

And because of the long-changing structural

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changes going on, we think that these economies of scope in many industries have gotten bigger, and increased importance of speed to market has become more important as well.

And just to illustrate an idea with an example, couple of years ago, this company Android came up with some better operating system. I believe that was an eight-person operation. And one of things that they could have done was hire more engineers, more software people, come up with some improved products and maybe come out with a better smartphone three years from now.

But what would they be competing against? They wouldn't be competing against Samsung and Apple's current model. They would be competing against Samsung and Google's model three years from now.

And Android decided, rather than to go public and build a hard product, they decided to sell out and approach some potential buyers.

They approached Samsung. I heard the story in Korea last December when I was there. And Samsung said:

Yeah, you got some pretty neat technology here, but we've got 500 in-house Ph.D. engineers and scientists. We don't need to buy your product; we can figure it out ourselves.

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And so instead, Google bought Android. And I've read that Google considers it their best acquisition ever.

I don't think that Android didn't go public because they were afraid of Sarbanes-Oxley compliance cost or lack of analyst coverage. They decided to sell out because they thought somebody like Google would be able and willing to pay a much higher price now because they could realize a lot of value, than if Android stayed as an independent company and tried to build itself up through organic growth.

So we call this the economies of scope hypothesis that a lot of, in particular, tech companies are selling out rather than going public, not because the IPO market is broken, it's not a public company versus a private company choice; it's a big company versus small company choice, that getting big fast is important, and very frequently merging is the way to get big fast.

So the idea is based upon structural changes in the product market that did not happen overnight. It did not happen in April 2000 that resulted in before then lots of IPOs, and suddenly after April of 2008 very few IPOs.

Well, what's the evidence supporting this

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idea? Well, one thing we could do is look at the profitability of small firms.

And this graph gives from 1980 to 2009 for companies that have been publicly traded for at least three years. So this is excluding recent IPOs. What fraction of them in each fiscal year are reporting negative earnings per share? And we divide this into big companies and large firms and small firms using a cutoff of $250 million in inflation adjusted sales.

What you see is on the bottom for large firms there's been a little bit of an uptrend in the fraction of companies every year reporting negative earnings. And you definitely see some business cycle effects there as well.

And then on top is the fraction of small publicly traded firms that are reporting negative earnings. And what you see there is in the 1980s there was a big increase in the fraction reporting negative earnings. And since then, a little bit of a continued upswing. And in every year, small companies are much likely to be profitable, more likely to be unprofitable than big companies.

Now, part of the reason in recent years in the last decade that companies have been having a greater difficulty reporting positive earnings is, for instance,

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Sarbanes-Oxley compliance costs. And so what we do is we say, well, what would the earnings have been if companies didn't have those extra costs? And based upon some estimates from SEC studies, we say, well, pretty big company, what if they had $2.5 million less in costs, and for a small company, what if they had $650,000 less in annual costs; what fraction of them would be profitable then?

And that's where those dotted lines come in from 2002 through 2009. And what you see is the big companies on the bottom. That gap between the lines, it's called 1 percent, that only a small number of companies that were unprofitable would have been profitable if they didn't have that $2.5 million extra in expenses. And for small companies, the gap is about 5 percent. So, you know, definitely compliance costs are making it harder to be profitable. But we -- the patterns would largely still be there.

MR. WALSH: These are earnings per share negative in a year?

DR. RITTER: Yeah, yeah, they're fiscal year.

MR. WALSH: Over five percent of the companies are negative in a year because they have $650,000 in compliance costs?

DR. RITTER: Right. That if you look in 2009,

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the numbers for small companies are 60 percent unprofitable, and it would be 55 percent -- in other words, there are about 5 percent of companies where a $650,000 change in earnings would shift them from being unprofitable to profitable.

MS. JACOBS: Can I ask a quick question?

DR. RITTER: Yes.

MS. JACOBS: The $600,000 estimate on the small companies, what was your market cap?

DR. RITTER: These -- there's no market cap being used here. $250 million in annual sales is being used as the definition of big and small companies.

MS. JACOBS: Yeah. I don't know how the rest of the members feel, but I don't think the $600,000 is a real number.

DR. RITTER: Now, this is the incremental costs.

MS. JACOBS: That's right, yeah.

DR. RITTER: And --

MS. JACOBS: It's the cost of being public, and I think we as --

DR. RITTER: Well, this is the change in the cost of being public --

MS. JACOBS: With SOX.

DR. RITTER: -- relative -- correct.

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MS. JACOBS: Yeah, got it.

QUESTION: Just a clarification, because of per 404, non-accelerated filers are exempt, does this account for that?

DR. RITTER: No, it does not. This assumes that every company with less than $250 million in annual sales has to pay an extra $650,000 in compliance costs as a result of Sarbanes-Oxley. So for a company, especially those exempt or since 2007, this might be an overestimate.

You know, there's a lot of evidence that the first year or two, when auditing firms were billing lots of stuff, that those numbers were bigger than they have been since then. And obviously for a biotech company with zero sales, the numbers are likely to be smaller than for another company that's got really complicated revenue and all sorts of complicated accounting.

Okay. Another question is: Of companies that are public, have a lot been going private? And this graph shows, of companies that went public, how many of them then went private within three years? Not getting acquired by a bigger company, but going private.

And what you see here is most years the number is about 1 or 2 percent per year. So of the companies that go public this year, we could anticipate that 1 or

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2 percent of them within the next three years will decide, we made a mistake, we're going private.

Being bought out by a private equity firm, for instance, would be going private. Going dark, going private. Being bought and acquired by a bigger company, we don't count that as being private. So this is not the big firm versus small firm issue; this is the private firm versus public firm issue.

Most importantly, this decade there has been no increase in the probability of going private than there used to be. So there doesn't -- you know, it seems to be something where a small number of companies that went public decided within a couple of years it was a mistake, but it doesn't seem to have changed much over time.

Now, before, we were looking at companies that were public for at least three years, what fraction are reporting negative earnings. These are companies that went public, and within three years of going public, how profitable are they.

So, for instance, in 1980 the numbers that are graphed there are for the companies for fiscal year 1980. Of the companies that went public in '77, '78, '79 that are reporting in 1980, what fraction of them are reporting negative earnings?

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And what you can see here is for the small firm IPOs the same uptrend for big -- for IPOs a little bit of an uptrend. But just as we saw it in the other graph, small companies are much more likely to report negative earnings than big companies.

And note that April of 2000 is nothing special here. It's not as if suddenly there was this dramatic change when the tech stock boom collapsed or when Sarbanes-Oxley came in or anything else. You know, we've got a gradual trend going on consistent with the notion that there have been some long-term trends going on making it harder and harder for small independent companies to make money.

Now, this is just tech stocks or just biotech stocks. A lot of numbers here. Not going to ask you to memorize all these numbers. The effects are a little stronger for tech stocks than for other industries. But the patterns are there for other industries as well, and the patterns are stronger for small companies than big companies.

MR. DENNIS: Professor, going back to your graph, it showed something like 60 percent of small companies are losing money?

DR. RITTER: Yeah. And here, for small IPOs, you see it's over 70 percent.

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MR. DENNIS: Okay. Well, yeah, I was looking at the earlier one:

DR. RITTER: Yeah.

MR. DENNIS: So you're saying that's not -- you know, when I look at the original bubble back in the '90s or so -- yeah, in that one. Let's see. Where it went from 20 to about 45 percent or so.

DR. RITTER: Yeah, in the 1980s.

MR. DENNIS: In the '80s, '90s. Now, my assumption without any fact is that that's more a high tech or start-up that. Are you telling me there's really not much difference? If we graph this for plain old manufacturing companies that we would see the same kind of relationship?

DR. RITTER: Yeah. Indeed, go to the numbers for Panel C would be the plain old manufacturing companies and retailers and others, fast food chains. We see that for the small companies in 1980 to 2000, 49 percent of those nontech companies were reporting negative earnings. The last decade has been typically 90 percent. So it increased, not as dramatic as the deterioration and profitability of tech firms, but the pattern is still there for other industries as well.

What about being acquired? This graph gives for IPOs what's the probability of being acquired within

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three years of going public?

And the orange lines give large firms; the blue bars give small companies. Once again, $50 million in pre-IPO annual sales being the definition of small versus large companies.

And we see a bit of an uptrend, especially in the 1990s, for those blue bars, that in the 1990s there was a pronounced trend, where in the early '90s very few companies that went public got acquired within three years. By the end of the '90s, a very large percentage of companies that went public got acquired within three years.

So the pattern of more likely to be getting acquired was there before the tech stock bubble burst and the low volume of IPOs that we see in this decade.

Everything we've looked at has been from the United States. What about other countries?

Here's for Germany. See 32 years, as the United States. The bars are the annual number of IPOs in Germany, one of the world's largest economies. The connected lines on the left-hand axis are the average for the returns on IPOs. And what we see there is a very different scale than the United States.

In most years in Germany, if we look at the 1980s, typically only 10 or 20 companies went public in

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Germany. They did not have Silicon Valley. They still don't. In the late '90s they had a bit of a tech stock boom, but it hasn't been there this decade either.

And if we look at other continental European countries, the patterns are very similar to Germany.

If we look at China, of course it's a different pattern. Lots of state-owned companies have been going public in recent years.

What about the returns earned by investors?

At the June meeting I believe Professor Jeff Harris gave some numbers from my website. These are obviously perfectly correlated with the numbers that he presented.

On the left-hand side here, we see for small company IPOs. From 1980 to 2000, the gray bar gives the three-year buy-and-hold return from the first date closing price to three years later, how much did investors earn. And what you can see there, an average three-year buy-and-hold return of about 7 percent, annualized only about 2 percent per year as small company IPOs. Whereas if you had bought other small companies on the same day as the IPO, sold them on the same day, you would have gotten that red bar, about 20 percent buy-and-hold returns. In other words, small companies underperform.

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What about the last decade? From 2001 to 2009, the difference in returns has been even more dramatic. You would have actually earned negative average returns on the small company IPOs, whereas you would have earned positive returns on investing in other publicly-traded small company stocks.

On the left-hand side, we've got large firm IPOs where there's basically no difference between the gray and red bars. For larger companies going public, they don't underperform other similar kind of companies either in the '80s or '90s or in this decade.

And if I were to break this out in more detail, in the 1980s, the small company IPOs underperformed; in the 1990s, they underperformed; in the bubble years, they underperformed; in this decade, they've underperformed. One of the few patterns that has been reliable, just period after period.

And, you know, maybe one of the reasons that investors are willing to pay as much for small company IPOs is they've learned, you know, after decade after decade of having so few of the companies become profitable and earn big returns for investors, they just had kind of a buyers strike. But it's not because investors are irrational; it's because the companies just haven't been turning the corner and becoming

profitable frequently enough.

MR. CHACE: The $50 million is the threshold that you used, right, for small companies?

DR. RITTER: Yes.

MR. CHACE: If you break that either by deciles or quartiles kind of market cap size, is the relationship linear to larger? Because my perception is that $50 million is a pretty small --

DR. RITTER: Yeah.

MR. CHACE: Hard to understand for sure.

DR. RITTER: It's linear as you go from zero up to 50. The lower the sales, the worse the returns are. Once you hit that $50 million cut-off, it's pretty much the returns are similar to other companies of the same market cap in value versus growth characteristics.

MR. CHACE: So it is kind of the smallest of the small.

DR. RITTER: Yes. Now, the reason I'm using sales rather than market cap is when you use market cap, you're combining both big companies like Facebook and overvalued companies like Facebook.

And in particular, in the bubble years you had a lot of really tiny companies at astronomical valuation that then crashed and burned. And if I did this on the basis of proceeds or market cap, the numbers would look

even worse.

MR. GRAHAM: To what extent do you think the lack of access to capital plays a role in small companies failing to provide a better return? Talking about a vicious circle in some cases here?

DR. RITTER: Yeah, yeah. Obviously there are some companies where if they had access to capital, they could have turned a corner. But I'd be -- you know, and there certainly are some companies that have a viable business strategy that weren't able to raise financing at sufficiently attractive terms, that they never did make the investment that would have turned out to be good.

However, if we look at the realized returns earned on venture capital investments over the last decade, which in general has been pretty poor, I'd be willing to assert that the problem is not lack of capital; it's lack of good companies, lack of good investment opportunities.

Indeed maybe even the problem has been too much capital resulting in low returns for both venture capitalists and public market investors. If the prices that investors paid were lower, the returns would have been higher.

Now, getting the balance right is not easy,

you know. For companies with good prospects, they ought to be able to raise money at fair terms reflecting their growth prospects. And for companies that don't have good investments, the market is working when the market refuses to fund those companies.

I'd be more concerned about capital formation being the fundamental problem if venture capitalists and their limited partners were earning incredibly high returns over the last decade.

I'm not going to claim that I know how to get things right, that I know what the right amount of capital is or what the right regulations are. But the main point that I want to make is that it's been really difficult for a lot of small companies, especially in the technology space, to come up with viable business models that earn positive profits and earn high returns for their investors as freestanding independent companies; that I think a major reason that a lot of companies are selling out, venture capitalists are exiting by selling out rather than taking their company public is because the company is worth more as part of a larger organization that can speed products to market, integrate technology, create value, than if the company was trying to grow organically.

MR. GRAHAM: So --

DR. RITTER: And there's not one business model that fits all for every company.

MR. GRAHAM: Right, it's a complicated question, and there are a lot of factors. But some companies fit some model, some companies don't.

DR. RITTER: I agree. And, look, my focus on IPOs has been for more than 30 years. I would really like it to be the case there is a vibrant market for IPOs in the United States and throughout the world.

MR. CHANG: These statistics are very interesting and informative, but I'm not sure where we're going with this. It's a little bit like the problem with the apple analogy. If you pick that one bad apple, I mean, you lost it, you lost your one buck.

So what does that really tell us in terms of from an investor standpoint?

DR. RITTER: What it tells us is that investors haven't been able to find enough good apples. That, you know, for every eBay and Google that have given investors really good returns, there just have been too many companies that have been disappointments.

Now, you know, just like with venture capital, the fact that a lot of the companies have lost money, that doesn't bother me. You know, venture capitalists are counting on the right skewness, enough tenbaggers to

balance out a lot of write-offs.

And when you invest in young companies, even if it's a public young company, a lot of them are going to disappoint. If there were enough winners to offset the losers, the average return would be fine.

But, you know, the evidence -- and I wish the numbers were different than they are. The evidence seems to be that there just haven't been enough companies that have been able to transform their business into a big successful business when they go public at a very young age in their lifecycle.

You know, and if we think about Microsoft, Google, they were already big, successful, profitable companies when they went public. That -- I have difficulty coming up with a lot of examples of companies that went on to big success that went public at a very early stage before they had demonstrated a fair amount of operating success.

MR. LEZA: On one of the -- do you have a chart? For example, there's been a lot of what I call structural changes.

In one of them, for example, and I've never seen a chart, is when you look at -- and especially if you look at high technology and you look before the bubble, you look at the multiples that people were being

acquired versus the multiples from a strategy point of view that are being acquired after the bubble, I mean, there's a tremendous change. Before the bubble, you never heard about a multiple from a corporation taking 7X, you know.

And that's a big change. And that's why a lot of people, you know, they'd rather take it now than wait and say, okay, let's go IPO and see what happens.

You ever done a multiple chart to show that?

DR. RITTER: I've done related things. Let's give another example here.

Facebook. The IPO has gotten a lot of criticism. It's still a great company. The only problem is investors made too high a multiple. You know, they built in expectations that were just too optimistic. You know, I still think it's a great company. I'm too old to be a user myself, but, you know, they've got a business model that's working. You know, maybe it's not going to be as profitable as some people had hoped it would be. Only time will tell on that.

By the way, Steve, how am I doing for time?

MR. GRAHAM: You're okay.

DR. RITTER: Okay.

MR. GRAHAM: I'm assuming that you're going

for another hour.

DR. RITTER: I won't take it that long.

MR. GRAHAM: You're good.

MR. BORER: Question: Given your years -- your years in the field and given some of these statistics we've seen, given that the number of transactions pertaining here down by 60 percent in IPOs, the number of trade sales by venture capitalists and private equity, strategic (inaudible) other companies in lieu of IPOs, is part of this return driven by the fact, in your opinion, that the better companies didn't IPO on average, went another route, and that the market itself of IPOs, given all the people involved, is not very good at discriminating between what's a good opportunity and a bad, and obviously over time efficiency prevails, based on performance, growth, profitability, etc.?

DR. RITTER: You know, it's clear, you know, with the benefit of hindsight in 1999, 2000, there was a bubble that investors were too optimistic in paying prices that were not justifiable.

You know, a year or two ago, lots of people were asking about social media companies, are we in bubble 2.0? And the answer I gave them is: I'm not sure. That in '99, 2000, I had no question in my mind that there was a bubble going on, just like six years

ago I had no question in my mind that there was a real estate bubble going on.

With social media companies like Facebook, the fact that Google is now making $10 billion a year in annual after-tax profits demonstrated how profitable targeted search advertising can be as a business model. If Google hadn't been so successful, Facebook would have never gotten the valuation that it had gotten to.

And a year ago, even six months ago, I was not at all positive that Facebook's valuation was too optimistic. You know, right now, I'd probably revise that answer.

But, you know, I don't think that it was obvious that the social media frenzy gotten has too completely out of whack. You know, most of the time when there is a bubble, you can tell a rational story or optimize. The only question is, is it too optimistic a story? And it's hard to quantify when you've got a lot of uncertainty about the future.

I'm not sure if that fully answers your question, but I'm not sure that I've got a single answer.

Okay. So let me just summarize the evidence so far. Small firm IPOs have become less profitable post IPO. There has been a dramatic decline in

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profitability after 2000, but that decline in profitability is not limited to tech firms, and there had been a trend going on for quite a while.

And mergers have become more common, both venture capitalists selling out in a trade sale and companies going public, and then merging. Either being acquired or -- I haven't shown it, but other studies have demonstrated that there has been an uptrend over time in other companies that do go public, how many of them make acquisitions themselves within a couple of years.

You know, so all of this is consistent with the notion that getting big fast, possibly via M&A activity, is increasingly the popular business model.

Evidence is also that small firm IPOs have generated disappointing returns. And the one way we can summarize this is eat or be eaten. You know, that getting big fast either as an acquirer or being acquired is increasingly the value-maximizing business strategy, not for every single business, but, you know, on average, especially in the technology space.

Now, I'd like to spend some time talking about analyst coverage and tick size, something that I and David Weild and Ed Kim will be talking about further this morning as well.

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In my paper, co-authored paper "Where Have All the IPOs Gone?" we track down from all the companies that went public from '94 to 2009 what was the analyst coverage on these stocks.

And we find that both from '94 to 2001 on the right and from 2002 to 2009 on the right, '94 to 2001 is on your left, that the gray bars are small company IPOs, the red bars are large company IPOs. Close to 100 percent of the companies that go public do get analyst coverage. That was true in the '90s; it's still been true now.

Of the handful of companies that don't get analyst coverage, typically there are very small firms or there's some special circumstance, or maybe the data is missing the coverage that actually was there.

A few years ago I did a separate study where I started out using a standard database, IFES, looking at analyst coverage, and then looked at the companies where IFES was complaining there was no analyst coverage. Started going to the underwriters' website and doing Google searches and discovered that almost all the times there actually was analyst coverage from the lead underwriters' analyst, it's just that IFES didn't list it for some reason or another.

Now, what this does not answer is: How many

companies aren't going public because they couldn't find an underwriter that was willing to provide analyst coverage?

And, you know, certainly there are some companies that are so small that any reputable underwriter is going to say, look, the economics just aren't going to work for me to have an analyst cover your company. Come back with -- when you're bigger, and then we can consider it.

But of the companies that do go public, it's pretty rare that they don't have analyst coverage. And usually coverage from multiple layers.

Now, regarding tick sizes and stock.

MR. WEILD: Jay.

DR. RITTER: Yes.

MR. WEILD: If I can, we've done studies on research -- we didn't bring them here today. But the ratio of number of research analysts to companies has definitely declined over time.

DR. RITTER: I agree.

MR. WEILD: And some of the stuff in the economic literature, and I'm not fresh on, that basically says that you need about six research analysts for stocks to trade, you know, more efficiently.

We think that the problem with research,

though, is not a research problem per se, that a lot of this research is sitting on the shelf collecting dust, that nobody is actively marketing it to drive liquidity. And so, you know, it's up there for show to make -- to make the issuers feel like they're actually getting something. But the actual amount of time that an analyst is spending with the company is -- is -- is -- can be pretty trivial. And particularly as you get into smaller companies.

DR. RITTER: I agree with you. I'm not sure that six analysts -- you know, there's no magic number. The more, the better. And by the time you're up to the 23rd analyst, the 24th analyst isn't going to make much difference.

Obviously the first couple of analysts are more important, and having analysts that really are involved, rather than just sitting there doing very little, certainly makes a difference as well.

MR. WEILD: Yeah, I agree, yeah.

DR. RITTER: As Kathleen Hanley pointed out at the beginning, bid-ask spreads have declined over time. For small company stocks before 1994, they were typically 25 cents or 50 cents; now more typically 1 to 10 cents, you know, sometimes larger than that. And for big company stocks, you know, one penny is a very

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typical spread.

At the same time, depth has decreased over the last two decades as well. You can't trade as many shares without the price moving a little bit.

And the reduction in bid-ask spreads for small stocks has been very good for individual investors who are buying less than a thousand shares of a stock.

For institutional investors that want to buy or sell a big block, the lack of depth has been a detriment to them offsetting some of the benefits of lower gross spreads.

This is a very simple summary of things obviously in light as more complicated issues go on as well.

Let's ask: How does a larger spread boost a stock's price? You know, the logic is wide bid-ask spreads are profitable for market makers. Profitable market-making creates an incentive to generate trading volume. Analyst coverage generates trading volume, so a securities firm that makes markets in a stock -- or makes a market in a stock has an incentive to have an analyst cover that stock or cover stocks in general.

So, you know, the logic, which I completely agree with, is wider bid-ask spreads don't make trading more profitable, that creates an incentive for a market

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maker to have an affiliated analyst generating trade volume.

Also, analyst coverage increases the demand to own the stock and hold it as well as trade the stock.

MR. WALSH: Professor, how do you define "securities firm"?

DR. RITTER: I would -- I'm thinking of that in terms of an integrated securities firm that does both underwriting, market-making.

And, you know, one of the market structure changes that's been going on in the last decade in particular is how specialists and market makers have largely been replaced by high frequency traders.

MR. WALSH: Which are essentially securities firms?

DR. RITTER: Yes, sometimes hedge funds being made to high traders. But certainly there have been some major structural changes there.

MR. WALSH: There are structural changes

coming down the road making it harder and harder for traditional securities firms -- Goldman Sachs, Merrill Lynch -- to make markets --

DR. RITTER: Right, I agree with that.

MR. WALSH: -- getting ready for the next chapter.

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DR. RITTER: And analyst coverage increases the demand to own the stock, boosting the stock price.

While I agree with this logic, the question is: Well, how big is the effect? What's the quantitative effect? Well, there is some evidence out there.

Actually, one of my colleagues, Mike Ryngaert, along with one of our former doctoral students, Cem Demiroglu, published an article two years ago where they looked at over 500 companies that had no analyst coverage where an analyst initiated coverage, typically by grading, and looked at what happens to stock price when the analyst started covering the stock. And they found that, on average, the stock price jumped 5 percent. And there was no evidence that it immediately decreased back down to where it had been before. And almost all of these were small company stocks with a market cap of less than $250 million.

So I think there, you know, is definitely quantitative evidence out there about just how much analyst coverage does affect a stock's price.

Now, this is a short run effect. If that analyst puts out a report once and then never does anything again, you know, ten years from now, I'm sure the stock would have gone back down to where it would

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otherwise be.

If the analyst, you know, continues to actively cover the stock, I would expect that the stock, after going up by 5 percent, would largely stay up.

But, you know, in the long run what happens to the stock prices is mainly dependent on the operations of the company. You know, if the company fails to execute, the stock prices, eventually it's going to go to zero no matter how many analysts are covering it. And if the company becomes incredibly profitable, the stock is going to be going up no matter how many analysts cover it. And more analysts will cover it, as the market cap increases. So we've got some quantitative measure.

MR. CHACE: I just have to add a little bit of skepticism to that, to put it politely, but I'm kind of skeptical of research, the effect of research on small and micro cap firms and its value.

Generally, my perception is that neglected stocks that get research coverage typically have something positive going on.

And I don't know the duration of this, you know, the 5 percent. It sounds like it's kind of immediate.

But I think there's some risk. And without

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having read the study, it's a group of stocks that may have some positive things going on.

DR. RITTER: You're raising a very good point. In one respect this might be an upper-bound estimate and potential overestimate in terms of -- you know, if I'm an analyst and I'm looking at some companies that are currently uncovered, and I'm thinking, you know, should I initiate coverage on this, when I start doing my due diligence investigation, if I decide, you know, this company's prospects aren't all that good, my incentive is almost certainly -- I'm not going to bother covering this.

Whereas if I decide, hey, yeah, this company has really got some good things going on, but the market hasn't discovered yet, I'm much more likely to decide to initiate coverage.

And so what's going on when I announce I'm covering the stock is I'm also telling the market about some good things that would have been eventually presumably coming out anyway. But I'm just kind of moving up the date at which the market finds out about the good news.

So indeed, it is difficult to disentangle kind of the information from the coverage itself. And it's very plausible to think, as you are, that we've got two

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effects going on that are compounded into this one number. And so 5 percent would be an overestimate.

It also depends on who the analyst is. If it's an analyst at Goldman Sachs who has got a lot of credibility already, there's likely to be a much bigger effect. If it's a no-name analyst at a regional brokerage firm, that hasn't got very good following.

MR. WALSH: There's also other kinds. The product firm that look to buy these things, hedge funds. Just because someone is an analyst doesn't mean they're the only expert.

DR. RITTER: Right. This is restricted to sell-side analysts from securities firms.

And there are a variety of reasons to treat any number with a little bit of a grain of salt and think about what else is going on as well.

You know, we've got some trade-offs. Wider bid-ask spreads increase the cost of trading, which, everything else the same, ought to result in lower liquidity and a lower stock price. So we've got this benefit to the company of a wider bid-ask spread encouraging their analyst coverage, but we've got a negative to the company of a wider bid-ask spread to make the stock much liquid.

And empirically, which effect is going to

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dominate? Well, partly it depends on how much bang for the buck do you get with more analyst coverage from a wider bid-ask spread. Is 5 cents the right bid-ask spread? Is 25 cents? Is $2?

Obviously too wide of a bid-ask spread is going to have such a negative effect on trading that the benefits to the company are going to be more than offset by that bid-ask spread that's too wide.

And I'm not sure exactly how to balance this, but obviously I'm quantifying what effects would be needed on what the right ticks would be.

Now, as I indicated before, how lower bid-ask spreads benefitted small traders, wider bid-ask spreads are a tax on small traders. If you think about this as a tax, why have an implicit tax of, let's say, as a bid-ask spread moves from a penny to 5 cents, well, that's a tax of 4 cents per share on a trade. Why do it in a disguised manner rather than just have a tax, you know, an explicit tax of 4 cents per share with a 1 cent bid-ask spread?

And the tax revenue could be paid directly to the analyst. So rather than having all these indirect effects, if the goal is to have more analyst coverage, why not do it in the most efficient way possible of, you know, raising money to pay the analysts directly?

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That then raises the question: Who should be taxed? Should we be taxing traders, or should you tax the company? You know, should a company pay $100,000 a year to pay analysts to cover the stock?

Well, a couple of years ago I was part of a NASDAQ/Reuters joint venture designed to get analyst coverage for uncovered small company stocks called the Independent Research Network, where this joint venture went out and talked to companies and proposed, look, for $120,000 a year, you pay us, the middleman, to go out and hire three independent analysts.

There's an obvious conflict of interest if you pay the analyst directly, you know, because everybody knows you're only going to be paying for an analyst if it's by recommendation and that analyst is going to have a lot of credibility.

But the NASDAQ/Reuters joint venture idea was: We'll be the middleman. And in return for you making a three-year commitment for analyst coverage, we will go out and hire three independent analysts who agree to cover your company for three years. And part of the deal is, even if that analyst puts out a buy recommendation, we still have to talk to the analyst. You know, we want there to be independence, so that in fact this analyst has credibility.

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And the idea is that this was not going to be enough money, you know, subsidy of maybe $25,000 per analyst per year to fully incentivize an analyst to cover a company where the analyst wouldn't. But if the analyst also generated some more trading volume and got soft dollars, you know, there would be additional sources of revenue for the analyst as well, but this would result in more analyst coverage for companies that were uncovered.

And what this joint venture found out when they went out and started marketing the idea to companies is there just weren't many companies willing to pay $120,000 a year.

So let me just wrap up.

You know, we've talked about a problem with declining profitability for small companies. I just talked about tick size to analyst coverage a bit. There are other possible explanations why there have been fewer small company IPOs that I'm sure you discussed already: the demise of Four Horsemen, fewer securities firms that can kind of focus on small companies, depressed stock market over the last decade.

But on the other hand today, both the level of NASDAQ and the S&P 500 are way above what they were in 1996. And there are a lot more small company IPOs in

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1996 than there are today.

The litigation environment certainly doesn't make it attractive to become a public company, but I'm not sure the litigation environment today is worse than it was 15 years ago.

Patent trolls are a problem for companies. But whether you're private or public, patent trolls are a problem.

So what about the policy --

MR. WALSH: What is a "patent troll"?

DR. RITTER: A patent troll would be a company or lawyers that buy out patents and then sue people, sue people for patent infringement. Basically they're trying to make their money from lawsuit settlements and royalties from owning the patents rather than creating value for society themselves.

So what are some of the policy implications? Well, the stock exchanges and some elements of the VC industry argue that structural changes, like subsidizing analyst coverage, lowering regulatory burdens, are needed to boost IPO activity.

And I'm sympathetic to these ideas. I think they would boost IPO activity, but my guess is quantitatively they're only going to boost IPO activity by a very tiny amount, that I think the main thing going

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on is some of these bigger structural changes that the fundamental problem is getting big fast is increasingly the profit (inaudible) business model. It's not a private versus public market issue; it's a big company versus small company issue.

So thank you for your thoughts and --

MR. GRAHAM: Okay. Thank you.

DR. RITTER: -- I'll be here the rest of the day as well.

MR. GRAHAM: Thank you.

Why don't we keep going and -- are you up for your presentation, David, or would people still like to take a break?

MS. HANLEY: Five minutes?

MR. GRAHAM: Five minutes? Okay. Five-minute break and we'll reconvene.

(A brief recess was taken.)

MR. GRAHAM: So we're about to hear from David and Ed. If we could all take our seats.

Okay. David and Edward, it's all yours.

MR. WEILD: Terrific.

Well, first, on behalf of Ed and myself, I'd like to just say thank you for inviting us back again. And any time that you can do something that in your heart of hearts you think really can materially benefit

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the U.S. economy, I think is just a very special and cherished opportunity.

I wanted to mention, before we kind of watch a couple of things about some of the data sets that we were looking at, we have, I think as everybody knows who saw me speak the last time, I like to say I'm a practitioner with an analytical bend. And one of the things that we've been able to do since we started publishing, we go around the country and speak at quite a number of events, to securities attorneys, we also spoke at the American Bar Association, Securities Regulation luncheon in Washington, D.C., the Securities Regulation Institute, at sell-side conferences sometimes. And we spend a lot of time with venture capitalists, people that sort of share -- some of the people that are on the board, the advisory -- the Venture Advisory Board of Silicon Valley Bank, I was in seeing Kate Mitchell, who chaired the IPO Task Force to the U.S. Treasury recently. Have known sort of the last five chairmen of the venture -- of the National Venture Capital Association.

And so what I -- what I, you know, heard pretty consistently over the last decade is that venture capitalists don't trust the IPO markets and are building companies for sale.

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And the first question out of their mouth, which is very different from a decade ago, is -- or 15 years ago, really, is, you know: Who are the natural buyers for your company?

And in our advisory practice, when we sit at the table with CEOs and CFOs discussing about their outlook, a lot of them will sit there and say: We just don't trust the IPO market. I don't want to get turned into a zombie stock. And these are profitable companies.

I'll give you a case in point. BigFix, which is up in Emeryville, California, just a little bit right over the Bay Bridge, and is a venture-funded company. And they had some volatility in their earnings. Profitable company. They just said: No, can't take the risk of how the market is going to treat us. If we miss a number, we'll never get dug out of the ditch. We'll lose our coverage, we won't get supported, we won't come back, and we will end up becoming effectively a zombie stock.

So they ended up selling to IBM for a very, you know, attractive price. Probably left quite a bit of money on the table.

But these are the kinds of decisions or discussions that go on at the board level every day.

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And I think that when you look in the sample set, sometimes there's a bit of adverse like -- two things going on.

One is that companies that have to go, you know, public, they don't have the alternative for being forced. They're probably not the creme de la creme in some instances.

Certainly biotechnology, because of the scale amount of capital, many times has to go public, and these companies are clearly, you know, needing the capital markets. And I think that it's -- it's created a kind of a world of dysfunction.

We're going to talk about economic incentive as we get through it, but we think that this is absolutely the critical third leg to the stool. And if you don't fix the economic incentives -- we're going kinda -- I'm going to rearrange the deck chairs here for you in terms of how you think about spreads, because I'm listening to the discussion here, and people don't think about spreads appropriately. And we're going to get into that.

Just by way of background, Ed, my partner here, traded equities for Lehman Brothers internationally, traded stocks on every market in the 1990s internationally. He was based in London. So we

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have, you know, a pretty fair sense of stock trading. He is actually a material science engineer out of MIT by training. And both of us actually have a little bit of a science background. I started out as an molecular geneticist. So we bring kind of, again, an analytical bent to sort of everything that we do.

And we're really passionate about sort of the transformative kinds of companies and investment that we think will spearhead next generation economic growth, if you will, the sort of creative destruction and reinvention of the U.S. economy.

And fundamentally, we think that by -- by harming the ability of the stock markets to support that process, what we have is a lot of creative destruction going on right now and not enough creative reinvention.

You have the draft of the paper which I distributed. I would urge you all -- I know it's a bit of a tome to read it. There's a lot of good information.

We talked about some of the -- we respond to some of the SEC discussion around the report on decimalization. We also talk specifically about what a lot of people are saying on tick size. Let's just say that we think that there's an avalanche of opinion coming in the direction that we have to increase tick

sizes from some pretty smart people. Ed will get into that; I don't want to belabor it.

But this is -- this study that we present I think is written for sort of the layman, if you will. And it's pretty much on point. And I just want to give you some conceptual -- a conceptual framework to think about stock markets, which is that at some point the stock markets are absolutely free, the entire infrastructure implodes. Okay. You need money to reinvest and to support the stock market. And I think that's intuitive.

So when is there too little money to support the aggregate infrastructure and ecosystem? It's a key question.

And these are all things about sort of tipping points that we don't think about, including, for example, when do you have too much indexation and too many exchange traded funds where all of a sudden stock prices start to detach from fundamentals? There's not enough -- there's not enough money. It's more costly to do fundamental research sales and trading than it is to use computers.

And computers are information mining strategies, for the most part. They're not information additive.

And if you all of a sudden get everything into the information mining bucket, stock prices are almost by definition going to detach from fundamental value. And the ability of markets to allocate capital will be destroyed. Okay.

Only question is, when do you reach that tipping point.

So by the way, the paper is pretty much complete -- there may be some typos, and which I apologize; Mark Graff should be through proofing -- and out in the public domain printed next week. The -- but we thought it was important to get it in your hands.

Now, this is an absolutely critical chart and got a lot going on. But I want to point out that it's not spreads, it's not tick sizes. It's two things going on here. Okay? There is a shift from a quote-driven market with Reg ATS to an electronic order execution market, an electronic order book market. That happens in 1998 with the implementation of Reg ATS, called Alternative Trading System.

So I'm going to give you a couple of definitions. One is the idea of a quoted spread, which is what Professor Ritter, you know, talked about, what everybody sees, which is what is the actual spread in the market.

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And the other is the notion of a bankable spread, which, as a trader, is how much money can I actually make.

And if somebody can step ahead -- we had this discussion last time. If somebody can step ahead of my bid for a penny, okay, then that -- even if the spread is quoted at a quarter point, my bankable spread goes from a quarter point down to a penny. So when you make that shift from a quote-driven market to an electronic order book market, okay, what happens is the bankable spread, which was equivalent to the quoted spread, goes down to the tick size.

So in 1998 -- and everybody is looking at decimalization, which is in 2001 here, okay, the key thing to think about in terms of the change of economic incentives, the massive shift actually occurs in 1998 with the implementation of Reg ATS.

And we're going from -- we go from a quarter point down to -- actually, there's two different tick sizes that -- that are in bold there. One for smaller cap stocks at 1/32 and one for smaller price stocks at a 1/32, and larger price at 1/16. This is the NASDAQ market.

Actually, in the appendix here you have a similar chart for what's going on in the New York Stock

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Exchange and on AMEX at the time.

And what you see is you've gone from a quarter point from most stocks down to a 1/16 or a 1/32, which means you lost from 75 percent to 87.5 percent of your economic opportunity as a trading firm.

So when we used to buy stocks on the -- in the old days on a -- on the trading desk, we buy 100,000 shares at $10, have a quarter point spread, bankable spread was -- because it was quote-driven market, it was a quarter point. And we could mark that stock up from 10 to 10 and a quarter, make 2 and a half percent, and dial for dollars, get salesmen on the phone to create an order flow. And that's how liquidity was created.

Now, all of a sudden, when you shift to an electronic order book market, whatever that tick size is at a 1/16 -- or a 1/32, 1/16 represents -- what is it? 6.25 cents?

MR. KIM: (Nodding.)

MR. WEILD: That I've gone from 25 cent economic opportunity to 6.25 cents overnight, because anybody can step in front of me for a 1/16 or 1/32 as the case might be.

MR. CHACE: Can I ask a question?

MR. WEILD: Yeah.

MR. CHACE: How responsible is high frequency

trading for that stepping-ahead dynamic that you talked about versus competition from other --

MR. WEILD: It's automated. I mean, you know, Dan, you're -- you know, it's a great point.

I mean, what we've done with computers now is that we have the systems that automatically play cat and mouse. So if you get into the box and you trade electronically now, I mean, automatically somebody is stepping ahead. You put in an order at a price, you know, somebody steps ahead of you for a penny. So by definition, it's causing this unnatural spread compression.

However, if you listen to others, they'll say that in the micro and the nano cap stocks -- micro being defined as sub $500 million and nano cap sub $10 million -- by the way, that's where most capital formation, IPO capital formation, historically live. That's the small IPO. Okay? Spreads are still pretty wide. Okay?

The problem is nobody can bank those spreads. You got the worst of both worlds. High spreads, no institutional liquidity. And if you do analysis -- we did this I think the last time, but you're seeing a shift of asset ownership in small micro-cap stocks to smaller and smaller institutional investors. It's not

that it's not there; it's just that they don't have liquidity constraints.

What it's saying is that liquidity is declining in small and micro-cap stock, so I've got to move down market. I mean, I've got to be a smaller asset manager because I can -- you know, my position size is a half a million dollars. I can manage half-a-million-dollar chunks, but if I'm from Fidelity with a half trillion dollars in assets under management, I can't make that math work. It's just I have to cover too many stocks to get to any real size in my portfolio.

MS. JACOBS: For the benefit of committee members -- I am not a researcher; however, I found this chart and this set of data so compelling that I went back after the data was presented to us last time and I asked my financing and accounting folks to go back. And the first question I asked was I asked to take our share price and plot it against, but then we decided against your timeline here because these are transactions of $50 million or less. Correct?

MR. WEILD: Right.

MS. JACOBS: So we took our share price. I got to thinking, no, no, no, too many extraneous things would affect the share price.

But what about average trading volume?

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Because there's -- liquidity is the real page 2 here, right?

MR. WEILD: Yeah.

MS. JACOBS: Both for investors and for the public companies.

So I asked them to take our average trading volume over that exact same chart and see what happens to our daily trading volume. And we had ended up with a coefficient of correlation of 0.91.

Now, so I don't need to show you what that says, but there is a consequence to all of this that affects every one of us in this room where the public companies are concerned.

MR. WEILD: Absolutely.

MS. JACOBS: It was dynamic. In fact the folks in the office, they couldn't believe it because we had always complained about Sarbanes-Oxley, and what happened to the share price and what happened to our coverage.

Well, go look at the average trading volume per day, plot it, and it's amazingly consistent with what you're saying, David.

MR. WEILD: I mean, it's a really -- it's a really thorny problem to figure out what -- you know, what the causes of this are. Because what happens is --

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you know, you got the dot-com bubble going on during the period that these changes were made, and it totally obfuscates what's going on in the lower end of the market.

And, you know, guys that are -- you know, one of my old friends was Dan Case, who was the head of -- president of Hambrecht & Quist years ago. He died in 2002 of a brain tumor. Terrific guy. Steve Case's brother, who ran AOL.

And Dan, you know, had said to me -- we had taken a run at buying Hambrecht & Quist and had a long discussion about it. And for a variety of reasons, the time wasn't right for them to sell.

So I got a courtesy call when they sold to J.P. Morgan. And Dan told me that a lot of people think we're going to be brilliant in top-ticking the market and selling it five times book.

But what we're really doing is we, you know, believe that these order handling rules and the electronic stock markets are going to make it impossible for us to keep the lights on in a bad equities market. The cash -- the equities business is going to become unprofitable.

And if you actually look at the history of when these rules were implemented, there were a lot of

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people that told the SEC that this was going to have a devastating impact on the profitability of the cash equities business, and they pretty much dismissed the people at the time, those particular concerns.

And I think -- I think that when I look at it as a practitioner, somebody who hired and fired people -- and by the way, one of the things on my resume is I ran back the -- the strategic planning for banking research sales and trading back when you could put all those together at Prudential Securities years ago. And so we made the hiring and firing decisions.

And I can tell you that when we were looking at small cap stocks after Reg ATS was put into effect, that we were cutting back commitments on the over-the-counter NASDAQ trading desk at the time because we just -- we couldn't make the math work.

Okay. Simple thing. Lots of stocks in a small micro-cap area are trading at 100,000 shares or less a day. Okay. If you look at J.P. Morgan, their average revenue per share at J.P. Morgan, this is their statistics, is one and a half cents. So let's just say that the revenue opportunity, earnings opportunity may be a penny. 100,000 shares, that's for the entire market, that's a thousand dollars' worth of profit per day. Okay?

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And a lot of that's going off in machines, so you maybe you're fighting for, if you've got a research analyst dedicated, a couple hundred bucks. Nobody is making an investment like that. 10,000 shares, you're down to a hundred -- a hundred dollars' revenue opportunity. Forget it. Okay?

So the economic opportunity here, the incentive, if you will, is -- is the vast majority of the problem here when you get to the dysfunction of small micro cap stocks and, in turn, the IPO market. With a hundred percent certainty -- and I don't want to be -- I don't want to be coy. You know, I have no doubt that this is what's killing the IPO market in this country.

So it has to be fixed. And I will tell you that it will be fixed.

MR. BORER: David, can I ask you a question? You do a great job, by the way. I was trying to get my mind to lay on the, you know, the development of ECNs, the establishment of the SOES system, which is taking money out of pocket, the settlement with the NASDAQ market makers back in -- you know, 10, 12 years ago.

Were those all at around the same time, between this '98 and '01, '02 period? Because I recall generally, I was sitting on (inaudible) --

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MR. WEILD: Right.

MR. BORER: -- SOES bandits (inaudible).

MR. WEILD: Right.

MR. BORER: The point here, it wasn't the dealers who were stealing the money; it was a system put in place so the dealer who really wasn't a brokerage firm could hire a bunch of day traders, put them on a NASDAQ platform directly for the trade, and then take the money from -- whether it's the Knights or the Goldmans or the Rothmans, etc. Is it about the same point in time?

MR. WEILD: Well, it started -- I mean, the two things that started before this was SOES -- SOES, I think was -- Ed, do you remember? Was it the late '80s?

MR. KIM: SOES was the late '80s.

MR. WEILD: But it had an effect. It started to undermine the profitability. Had Instinet there too.

Well, what happened was you still could quote, and so you could still buy and manage the spread, if you will. You could buy it at 10 and mark it up a quarter. Okay? Because while the trades would go off within the spread -- it used to drive retail crazy because they'd see ticks -- you know, they'd see trades go up within the spread, and they'd say, why didn't I get that price?

And then you'd -- but what you would be doing

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is you would be negotiating -- because all the SOES and the Instinet for the most part -- Instinet was a little junkier, but SOES was all 100-, 1,000-share increments, whatever you had in the -- what we call the NASDAQ Level III machine at the time. That was -- you would put in either a hundred with -- your market size was either a hundred or a thousand shares by convention. So you would get picked off. The SOES bandits would bang the bid, and so people would start ducking away and you would see the market makers just drop in seriatim as each of them were taken out by a so-called SOES bandit.

But you still were able to monetize or bank that quarter point for the most part. People were able to hold that in place.

And so the degradation, you're right, had -- was starting. And, you know, in some respects, if you look at the sub $50 million dollar tranche, which is the blue there of IPOs, you know, you're seeing some degradation, if you will, as a percentage, whether or not that's statistically significant. But, "phoomp," it drops off a cliff in 1998 when we go from a quote-driven market, with SOES and Instinet in between, to all of a sudden everything is electronic posting of orders.

So we take all of the order handling rules that you've gotta -- you've gotta post your orders into

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the market, but there was no way to really handle all those retail limit orders.

Now, all of a sudden with the ECNs coming into -- into existence -- the Brutes, Ready Books, all the -- all the electronic order books, boom, everything is getting posted into the market in 1998, which starts the degradation of that -- of that -- of that quoted spread.

So the quoted spread becomes much less important, and anybody that wants to sort of step -- restart that whole business of stepping in front of -- in front of -- in front of quotes, quote market's blown to bits. And that's why when you -- you know, you go through this, it is -- it is really that kind of shift.

And so, you know, very simply, there's three ways to improve economics, right?

One is commissions. And commissions don't -- we talked to a lot of institutional investors. I talked to Wasatch's folks, but -- you know, trying to get a sense of what works and what doesn't work. Commissions are horrible for small cap growth money managers, because what it does, it goes into expense ratios, and Morningstar gets all over it.

Tick sizes are actually a pretty interesting way to improve economics because it gets into the cost

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basis from an accounting standpoint much better.

And then you could go back to a quote-driven market, but I don't think anybody is going to do that, right.

So the only way, if you understand the formula, is that bankable spread, you know, is -- you know, in a quote-driven market is pretty much equivalent to the quoted spread, but in an electronic order book market, bankable spread is equal to minimum tick size. And by definition, you have to take up tick size to improve the economics.

So that answer the question?

MR. BORER: Very helpful.

DR. RITTER: I agree with you that wider tick sizes increase the economics for securities firms trading stock. You said that the lower tick sizes were killing the IPO market.

Could you quantify how much higher stock market prices would be if the bid-ask spreads were -- if the tick sizes were wider?

Are we talking about a stock, micro-cap stocks that are currently trading for $10 a share, would they go to $28 a share or to $10.12 per share?

MR. WEILD: Well, I think it's a -- first of all, the last time, Jay, we had an exhibit, which I

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don't include here, you look in the old material, about what's the profitability of the $25 million IPO. And I don't know if it's in this batch. It's in one of our papers.

But what happened with this shift was that the -- that you used to basically double -- as a book running manager double your profit potential on an IPO prior -- when we were looking at a quote-driven market. And when --

MR. KIM: Appendix E.

MR. WEILD: Is it Appendix E? Okay.

And then all of a sudden we went to losing money to support stocks in the aftermarket on the $25 million IPO. And I know that math because I did this for a living. Right? We --

DR. RITTER: Okay. So the problem is investment bankers aren't making enough money, so why don't they increase the gross spread from 7 percent to 14 percent if they want to double the economics?

MR. WEILD: Well, it wouldn't -- wouldn't solve the problem because every day that I have to provide support in the aftermarket is a day that I lose money. So you'd just be overpaying the investment bankers on the front end. And, you know, what you're really looking for, you really need aftermarket support.

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And another one of the great, you know, misconceptions to the market is that everybody looks at research as the aftermarket support proxy, right, the market for aftermarket support. In point of fact, what it is is a salesman making phone calls and people committing capital in a liquid stock.

There are two types of stocks, broadly defined. I mean, the market is actually in continuum.

One is symmetrical order book stocks where you have lots of buyers offsetting sellers. It's the natural state of the S&P 500.

And then there's asymmetrical order book stocks. Big buyer, no -- no offsetting seller. Big seller, no buyer. And what happens is somebody's got to go out and create liquidity for the institution.

And so what happens is, is that you can still play around in those stocks as a retail consumer, you know, with a hundred thousand shares, blah, blah, blah. But when you have to get a -- when you have to put up -- you know, you have to put up 500,000 shares of stock and acquire that kind of position over time, you know, you're going to get bored with it. You're not going to be able to do it. You're sitting there playing cat and mouse and ultimately you flush the position.

And that's what institutions that are playing

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in these markets tell me they do all the time. You know, they got sold on the idea, and then they can't get enough to make their -- make it work.

And so now you have to -- as a CEO, you have to figure out, can I put some kind of a shelf registration or something in, or do a PIPE transaction to get them started with some volume? It's a very, you know, ineffective kind of, you know, as a practical matter, market to bring institutional liquidity into it.

And what we're seeing is like -- you know, my -- back to my old analogy of flesh-eating bacteria, you know, you're gradually -- you're gradually from the bottom up, you know, eating out this infrastructure to support, and institutions are gradually saying, okay, not enough liquidity, liquidity is dried up, and I'm moving out of the market.

So the more that you start shaving ticks -- and this is one of the dangers of sub-penny quotes, sub-penny tick sizes, is that if you apply them to micro markets, you actually then start pushing this stuff higher and higher into the marketplace. You can get away with it for S&P 500 stocks, but you can't get away with it in the -- in the micro caps, the small caps and micro caps. So --

DR. RITTER: Have you answered my question?

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MR. WEILD: Well, your question is -- you know, your question is where would the share prices be, right?

And I think that -- I don't think you -- I -- this is my judgment: I don't think you can answer that question. Right? I mean, I don't know -- I don't -- from a scientific standpoint, I don't think you can answer it.

The fact of the matter is these stocks lose their visibility. Right? And when -- the natural state of most companies is they need visibility creators. Okay. And companies are struggling to get visibility with investors all the time.

Now, they're very different -- there's two types -- two types of stocks from a visibility standpoint. In our consulting practice we talk about supply push and demand pull.

A demand pull stock is like a Zynga, somebody that has great -- great visibility in the consumer markets. It sort of creates its own demand. Facebook was a case in point. And so it's not Wall Street creating their demand; it's the stocks and the brands created their demand. Tesla Motors. The vast majority

of these people are actually getting on the phone and selling the story. And when you take all the visibility
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creators out of the market, Jay, you have to be hurting share prices.

DR. RITTER: Yeah, but -- but it seemed to me that there's a very simple way to quantify this. To look -- you were talking before about the dichotomy between the liquid stocks, you use symmetrical, asymmetrical.

MR. WEILD: Yeah, it's an academic term.

DR. RITTER: Why not look at the price earnings ratio of the symmetrical versus the asymmetrical stock before 1994 and now?

Wouldn't that be a way of quantifying the change in the relative outcome?

MR. WEILD: It could, but you have to ask the question, what's in the sample set?

You know, good companies -- you know, companies that have alternatives are saying, I'm going to sell out. You lose them, you know, you lose them from the sample set.

You know, there's a lot of guys with alternatives that just throw the towel in and say, this market is too dysfunctional, I can't get the thing to work and I'm going. And so that's what you're hearing from practitioners.

So I'm very -- I'm very skeptical that you can
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cut all the numbers you want, but you have to take into account what people that are making these decisions every day are doing. And a lot of them are just saying, keep me the hell out of the market. Excuse my French.

So why -- why getting markets --

DR. RITTER: (Inaudible.)

MR. GRAHAM: Let's just go -- let's just go on.

MR. WEILD: What? Why getting markets right matters.

You know, look, I plead guilty sometimes to being a little Pollyanna-ish, but 20 percent of kids in the United States are living below the poverty line, and 40 percent of children are -- are -- are under what they -- what's defined as low -- lower income. And this is from the National Center of Children and Poverty.

So anything that we can do that is going to drive job formation -- and I pull my hair out a little bit sometimes with -- with unions, because union -- union members are typically not day-trading stocks.

And what happens is if you can drive more companies into the public market and more -- more volume, you're going to create greater tax revenues, which is going to go into the coffers and municipalities, which is going to allow us to employ

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more -- more teachers, firemen, and policemen. These things are all related.

And when you -- there is nothing more important in the United States to consumer confidence than a functioning IPO market. I mean, anybody here, and there's a lot of people that are old enough, remember what -- there's a lot of things wrong with the dot-com bubble, but it certainly gave everybody a sense that there was an opportunity, and there was a lot of entrepreneurial fervor.

And one of the things that gets lost in these job creation estimates that we do is the impact on the private markets, which is that you're going to invest a lot more money, take a lot more private company risk in this country if all of a sudden you see that the IPO market works.

Also, it has an impact on the M&A market. And I'll quote Ray Rothrock, who's the current chairman of the National Venture Capital Association, who says that it takes an IPO market to keep the M&A market honest.

So, you know, we have said, what did the JOBS Act do in broad terms?

It did a couple of things. It lowered cost for issuers, and it improved issuer communications with investors.

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And we say that there is an actual, essential third leg to the stool, that without that, you will not -- and this paper actually calls for JOBS Act 2, Part 2. You have to improve economic incentives to support especially small cap stocks. And the way you -- the way to do that, the best way to do that is to increase tick sizes.

There's just a couple of guys recently -- and we have these quotes in the study that we circulated.

There's one from John Bogle: "The financial system has been wounded by a flood of so-called innovations that merely promote hyper-rapid trading. Individual investors are being shortchanged."

We have Professor Schwartz. And I don't know if you know Bob, but Bob does this conference in New York for the trading community, the exchange community. And it is probably the best -- of course, he's been doing it for years and years and years. And Bob said in his opening remarks last year that, "Markets are still adjusting to regulatory changes like the Order Handling Rules and Reg ATS that were made over a decade ago." I mean, again, back to the flesh-eating bacteria.

Then finally, Arthur Levitt, and this was on "Bloomberg Surveillance" very recently, August 2nd. And Arthur said, "The irony of this is that the change in

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the Order Handling Rules in 1997 that were instituted under my watch at the SEC has resulted in the proliferation of markets, technologies, and automation that brought about the flash crash and yesterday's" -- he's speaking about Knight Securities' algorithmic issues -- "events. I think public confidence is severely shaken by things of this kind."

And then my point is, is that there's just lots of unintended consequences. And people are beginning to realize that these two things, Order Handling Rules and Reg ATS, had a pretty profound impact on how markets change -- and while Arthur doesn't say it, I will say it -- killing the IPO market.

Supportive observations from micro market economists. And this is recently James Angel: "A large relative tick provides an incentive for dealers to make markets and for investors to provide liquidity by placing limit orders." I know that Jim has spoken to this Committee before.

David Allen, Josephine Sudiman in Indonesia. Okay. This is an academic paper. "As tick size is diminished, encouragement is given to front runners."

This is what we mentioned before, right, stepping ahead. Traders are more reluctant to show their orders. Things move into dark pools.

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By the way, you have to be careful when you set tick size. You can't allow people to do all these rebates and trade within the -- within the tick size because then you defeat the purpose of the economic incentive that you're trying to create. So if you do payment for order flow, and if I earn a nickel, for the sake of argument, and I can share that with somebody, that this intermediates my tick size again.

David Bourghelle and Fany Declerck: "We find that a relatively coarse pricing grid," okay, higher tick size, "encourages traders to submit and expose limit orders, while a tighter price grid induces frequent undercutting strategies."

Michael Aitken and Carol Comerton-Forde in Australia: "Stocks with relatively" -- "with small relative tick sizes and low trading volume experience reduced liquidity."

And Ed, he's going to talk about that in a little bit.

But you cut tick sizes in micro cap, small cap stocks, you harm liquidity.

I'm sorry. I think that -- go ahead.

MR. KIM: No, you're on a roll. Go.

We've talked about -- thank you, by the way, for letting me -- letting me talk to you today.

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We've talked about the importance of tick sizes, and it's not just -- although the focus is on small and micro cap stocks, it's obviously critical for large cap stocks as well.

And the studies have shown, both in academia and practically by practitioners, that smaller tick sizes do increase liquidity for large cap stocks, but they absolutely decrease liquidity for small micro cap stocks, which are -- which are naturally illiquid anyway. And so they just -- they -- they aggravate the current situation.

What smaller tick sizes do for large cap stocks, however, that is violently negative is it encourages and fosters this gaming behavior, this undercutting or stepping-ahead behavior, where -- whereby the high frequency trading firms and everybody that isn't a non-fundamental trader, a non-fundamental investor can be in and out of stocks -- for no reason that is tied to investment, for no reason that is tied to the long-term interest in the company, but is purely about gaming for a penny in and out.

We have created a market that is absolutely a market that a high frequency trader would have designed, and is absolutely not the market that a long-term investor has any interest in.

And the -- if we can introduce larger tick sizes, we can restore the conditions that created the fertile ground that we had for IPOs for so long. So I'm going to go through this, because I know we're running a little bit -- a little bit late.

MR. GRAHAM: You're -- you're doing fine.

MR. KIM: Milton -- Milton Friedman said there's -- to paraphrase, there's no such thing as a free lunch.

And for us, it all -- it boils down I think to economics. And with respect to Professor Ritter's findings about economies of scale and economies of scope, I do think that at the end of the day it's all about the dollar.

If you follow investment banks, as an example, which are -- which are critical for all this, we're talking about restoring economics for investment banks. Investment banks are only going to do the things that make them money. It's not an indictment on the banks. It is -- they're purely logical creatures. If Goldman Sachs and Morgan Stanley could make money in small caps, they'd be doing it. They'd be doing it all day long.

The fact that the small cap market has been abandoned by the Goldmans and Morgans, the fact that nobody has come in to replace Robertson, Hambrecht &

Quist, Ellis, Rothschild, and Montgomery Securities, nobody can make money.

If you look at what happened before Reg ATS, or the conditions that existed before Reg ATS, you had, as David alluded to, bankable spreads of a quarter a share, 25 cents a share, which in the ensuing period dropped to essentially a penny a share, a 96 percent reduction in -- in the bankable spread, in the economics to run the business.

If you take a business and you suck out 96 percent of the funding for that business, that business cannot survive.

MR. WEILD: It's okay for naturally liquid S&P 500 stocks to let the orders interact, if you will. I mean, there's enough incentive because of the sheer scale volume. Some of these stocks trade in 20 million shares a day. Right?

But when you get into things that are trading episodically and trading in increments of 10,000 or 100,000 shares a day, it decimates them. There's just not enough money in at -- when you go from a quarter down to a penny.

MR. KIM: You have 167 different investment banks book running deals in the early '90s. Post bubble and post all of this, you were left with 39 banks.

There's even fewer today who are -- who are running deals.

MR. WALSH: You wouldn't say that across myriad industries -- across --

MR. KIM: Across myriad -- across every industry.

MR. WALSH: That, to me, is irrelevant. So what?

MR. WEILD: No, I think --

MR. WALSH: Banks, are there 2,000 fewer commercial banks in the States in that time period?

MR. BOCHNOWSKI: More than that.

MR. WALSH: Okay. So --

MR. WEILD: What's happening, which is catastrophic, is people are focusing on scale volume. They're looking at economies of scale to move their meter. You're a larger -- you're dealing with larger and larger institutions that have no incentive to support, you know, small and micro cap stocks.

MR. WALSH: I disagree. I think these high frequency traders -- I don't want to belabor things -- but they're essentially replacing --

MR. WEILD: How?

MR. WALSH: -- they actually replaced them in making liquidity.

MR. WEILD: Oh, that's -- that's the biggest joke on the face of the planet --

(Talking simultaneously.)

MR. WALSH: (Inaudible.)

MR. WEILD: -- the fact that -- that's not liquidity, guys. Average holding period is 11 seconds. Okay?

(Talking simultaneously.)

MR. WALSH: (Inaudible.)

MR. WEILD: How is that liquidity? Does anybody call -- call somebody and create an order on the other side? It's not liquidity.

MR. WALSH: But --

MR. WEILD: It's volume, it's volume. 70 percent of that stuff right now is volume. There's no liquidity. It's the biggest lie that's been perpetrated on the market that that's real liquidity.

MR. WALSH: And -- okay. If you want to go back to the pre-'97 days, the way that the regulatory is set up right now, these banks can't hold the train.

MR. WEILD: That the banks can't what?

MR. WALSH: Basel III coming down the road, investments banks can't hold them to it. The Volcker rule, I mean, they're basically telling you they don't want people holding -- they don't want investment banks and

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commercial banks.

MR. WEILD: I mean, when you run a trading desk -- first of all, you're not a storage department when you're a market maker. What you're doing is you're running a portfolio of long and short securities. And so the actual capital committed to facilitate liquidity is not huge, and it never was in the old days.

I mean, you know, I'll run -- I'll run an equivalent -- if I want to be market neutral running a trading desk, I'm going to be -- I may have, you know -- I may have 1,000 positions out, 500 -- 550 of them are long, and 450 of them are short. That's the way you do it. Okay. So the actual capital, out-of-pocket capital commitment is not huge.

And so what was huge was the incentive to get on the phone to find the other side of the order when somebody needed -- needed liquidity to be made.

I mean, there's -- the big difference between S&P 500 stocks, you don't -- nobody was really making markets *per se* in large cap stocks.

There's something called the Amivest liquidity ratio, which looks at -- and by the way, liquidity is how much stock can I move over a defined period -- a defined period of time within a price tolerance.

And so you would find the Amivest liquidity

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ratio that -- that large cap S&P 500 stocks would be over a half a billion dollars a pop. So there was no specialist that could commit a half billion dollars' worth of capital to move a stock 1 percent. They just wouldn't.

So if you talk to Dick Grasso, which I have, and Richard Bernard, who was the old General Counsel at the New York Stock Exchange, they had an allocation system. And they were actually, as a public policy matter, enjoying excess profits on large cap stocks to subsidize liquidity in micro caps. That's what went on.

Okay. But what happened was, those subsidies, when you went -- when you convert to markets with Reg ATS and then ultimately NMS, the ability to do all that left the market and --

So large cap, you know, again, you know, you have natural liquidity, natural visibility, back to the kind of the demand pull versus supply push stocks. Micro cap's natural state is -- is supply push. People have to get on the phone and create visibility. And that's what's gone from the market.

MR. BORER: Because I live in this ecosystem, I have for a long time, the number of market makers and underwriters and those types of things around 20 years ago, I'm familiar with some of the names you mentioned

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earlier.

There was -- there was not the gigantic gulf that there is today between the few small firms that will take on an underwriting firm for a company. And up to the Jeffrey Siebold or even, you know, Raymond James type people, from Loewen, Goldman, Citibank, Credit Suisse, CPS, etc. So there's -- that group of people has completely gone away through acquisition or just dissipate, going out of business. There are no new -- you know, take ten people out of Credit Suisse, start a new firm, all of a sudden you have option for -- you know, which becomes a firm. It's not happening. And I'm not sure exactly why.

But I know I watch all the [SafePlace?]. This is a very interesting thesis because margin came out of it, not only the big end, but the small end. I think that's what's taking place.

So to say that the 39 could do what the 167 used to do, they may, but they won't. Credit Suisse is not going to do a $40 million deal. That seems to be the decline in --

MR. WALSH: There's also Morningstar.

MR. WEILD: They don't do underwriting.

MR. WALSH: Not underwriting, research, research.

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MR. WEILD: No, but they don't call anybody on the phone who's putting out research. So again it's the demand pull versus --

MR. WALSH: Still follow -- the world's changed, in my opinion.

MR. WEILD: That's to the point --

MR. WALSH: Also in 1997 there was ability to enter, right?

MR. WEILD: You want to have a robust IPO market with robust aftermarket support, you want to drive job growth, economic reinvention in the U.S.

economy, you gotta put incentive back to support small cap companies that require capital and actually drive growth.

And if you don't, the world's changed because -- remember, it's not the market. We create markets. We create market incentives. You know, the notion of the market decides, nonsense.

We created this market. We had the old quote-driven market. We put a carrot out there. You look at the credit crisis, we decided that we were going to engage in liar loans and low interest rates, teaser interest rates and no-money-down mortgages. And what did we do? We created a bubble because we changed the incentives. We changed the market structure. We

changed the market structure here.

You gotta put it back to create incentives if you -- if you care about this market. It's -- it's binary.

MR. KIM: The one point I would make about -- you had said that high frequency trading firms (“HFT firms”) have replaced the old investment banks. And I think that's -- I think that's a very unfair characterization.

High frequency trading firms live in the upper end of the market, they live in stocks that trade anyway. They create zero liquidity on the low end of the market. And all they're creating really is additional volume at the high end of the market.

So I don't think that HFT firms, despite how they might want to portray themselves, have been anything but -- but a negative for our markets.

DR. RITTER: You're saying for the micro cap stocks, high frequency trading firms are --

MR. KIM: They don't trade there.

MR. WEILD: They don't trade there.

DR. RITTER: And yet you're blaming them for causing a problem there?

MR. KIM: No, no, I didn't say that. I don't think I said that. No. I was trying to address Mr. Walsh's comment about HFT firms replacing what the

investment banks used to do.

DR. RITTER: Okay. But if HFT firms aren't replacing investment banks with small cap stocks, why is there a problem for investment banks?

MR. WEILD: Because the economic incentives are gone, Jay. There's nobody -- nobody replacing what the investment banks used to do for those small cap stocks.

DR. RITTER: And what's your explanation for why this spread has fallen there, then?

MR. WEILD: Well, first of all, a lot of those small micro cap stocks -- I mean, I don't know, you're -- I mean, I've been told that a lot of those spreads are pretty fat, right? So --

DR. RITTER: They are.

MR. WEILD: They are. Okay. And it's not a spread issue; it's a bankable spread issue. Anybody can step in front of you for a penny. So, you know, if I need to get size done and I'm hanging out there, somebody will step in front of you, Jay, if you're sitting there trying to buy two -- getting 200,000 shares done, and they sniff that out, they will be in front of you.

Now, the reason why the high frequency guy -- by the way, if high frequency was adding liquidity,

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don't you think that they would be on the press and in the market which is the most illiquid, which is the micro caps? No, they're not there. They don't add liquidity.

But there's -- you can't get something done in the micro cap/nano cap space because people aren't willing to make the risk. They're not making outbound phone calls.

Micro cap liquidity is created by getting on the phone and selling investors; stocks are sold, they're not bought for the most part, with the exception of the demand pull stocks, the big brand names, you know.

And so what we've got is the -- what's the median equity market value of a listed company in the United States? It's $450 million.

DR. RITTER: Okay. But what I'm having difficulty understanding is, if the bankable spread has decreased for the small cap stocks, who is it who's stepping in front?

MR. WEILD: If I want to go position 200,000 shares of stock right now in the market, I need to hold that spread intact to be able to mark it up. If you say the spread was a dime, it was 10 cents, and I buy it at ten and I want to mark it up to ten-ten, okay, the

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minute somebody gets wind of the fact that I'm doing some size in that market, they will step ahead of me for a penny.

DR. RITTER: Okay. Who is -- who is this? It's not the high frequency traders.

MR. WEILD: Anybody that has a trading machine and an algorithm that sits there and sniffs something out will be in front of me. A human being that sees me do that will step in front of me for a penny.

MR. KIM: The high frequency firms are going to go wherever -- wherever there is significant and sufficient volume. That's where they'll live. They live now -- they live now, and they've lived for years now, at the high end of the market. They're not creating any new liquidity at the low end of the market. If we try, to David's point, their algorithms would sniff out any irregularity, any -- any difference in the normal day-to-day volume. And any attempt to introduce, you know, a position of 30 days' worth of trading volume, for example, into the lower end of the market --

MR. WEILD: I can't --

MR. KIM: -- it wouldn't work.

MR. WEILD: I can't get compensated for taking that risk as a trader, Jay. Okay? I mean, if I'm sitting there and I'm hanging out and I make a capital

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commitment on 200,000 shares of stock at ten bucks a share, $2 million, the risk then, probability of it that somebody sees me doing that, buying that stock, and pushes it down to a lower price, it -- it -- my upside potential is capped at a penny, if somebody -- if somebody steps in front of me for a penny, and my downside is that I'm long 2 million shares of stock that somebody pushes down a nickel or a quarter, the math doesn't work any longer. It's just that the model is dead.

And that's what you've seen in terms of wholesale shifts in markets. I mean, I'm looking at John. You know, John Borer, but your firm, you know, people used to make a lot of money getting on the phone, creating visibility.

Again, it's not -- it's less a research problem. It's, what do you do with the salesmen, the sales traders all making phone calls? They're the amplification system, if you will, for research.

Research gives you a pretext for a conversation, but he's only one guy. So how many phone calls can he make?

But if you need to move size, a block of 200,000 shares, and you've got a sales force of 35 guys and, you know, 20 sales traders, all of a sudden people

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are out there finding the other side of the order. But they have to be incented to do that.

And if you position it -- and the upside is now down to a penny because somebody can step in front of you for a penny, you will -- you will very quickly lose a ton of dough committing capital to those stocks.

You know, Dan, I don't know at Wasatch, but, you know, people used to commit lots of capital in the micro cap names. Nobody commits capital down there any longer. You know that.

I mean, I'm not telling anybody -- this shouldn't be revelatory, at least for people that are in the business. People don't commit capital. Get on a trading desk. Okay. And for those of you that were on the trading desk 15, 20 years ago, it was a pretty noisy environment. People were talking to each other, picking up the phone. Now you can hear a computer. You know, all you -- all you -- all you hear is the whir of computers. It's deathly silent. But there's nobody, nobody on the phone.

And, in fact, if you go to a morning call, institutionally, one of the things that happens is that, you know, they -- a lot of times they -- the research salesmen will get voicemail. And they've automated things with computer-aided telephone, and they just take

a -- one voicemail message and they -- if they get the voicemail, they just drop it into the voicemail box. They hit the button, hit the button, hit the button, hit the button.

So that -- those things have changed the whole ability to market. And you've been forced to do that because the economics of the business are just unprofitable. So you're only paying for a trade, for a trade execution. That's what's in the market. All the value components that are required to support a small cap infrastructure in this country have been starved.

MR. CHACE: Can I ask a bit of a different question? I mean, we were talking about markets, and markets have provided innovation and created value in finding ways to capture that value. And Professor Ritter has argued that there's value in research coverage in terms of higher stock prices, and hopefully in terms of generating ideas for investors to make money. You've argued -- or I think would argue that there's value in providing liquidity to institutional investors to buy and sell securities in bulk.

Are there alternative models? I mean, beyond what I think I kind of read this, and I'm not an expert by any means, but it kind of feels like a tax on investors to fund something.

But are there different models rather than tick sizes that would sort of facilitate what you're describing?

MR. WEILD: Well, it's an economic incentive issue, Dan. And I, you know, mentioned there's three ways you can be: You can either be back at a quote-driven market, you can up commissions, or you can up tick sizes.

But the one that I think works for institutional investors, from my conversations with, you know, Karey, you know, Barker, we talked about the accounting issue -- that's one of the senior -- you know, one of -- one of Dan's colleagues -- is -- is it has to be in the cost basis, the stock and mutual funds to work, and tick sizes does that.

With commissions it will actually go into the expense ratios. And then Morningstar ratings for small cap growth managers would actually look less attractive relative to large cap funds. And that wouldn't -- that wouldn't get us where we need to go.

So it's economic incentive.

There may be a different way that I haven't thought of. I'm not a proponent -- for instance, there's been some discussion in Congress about just flat out, you know, because of the high frequency stuff, just

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taxing stock transactions. But the problem is that then the money doesn't go into the -- you know, into the market, into the ecosystem. And if you don't have a -- have an economic linkage with the tax, with the value creation of that, which is creating the liquidity, then why are people going to get into the business of creating liquidity.

And one of the reasons why that model you talked about, the research -- the paid research model that NASDAQ and Reuters tried to do, one of the reasons why it failed was also because -- not because simply it was $120,000, is that it was $120,000 for a research report that wasn't going to then actively get marketed because there was no economic incentive to market it in the aftermarket and drive volume and visibility.

So you got research coverage, and it works for some institutions and some investors that are smart enough to go track down the research, but it doesn't actually do the other piece of it, which is create active visibility and active liquidity through marketing.

Does that make sense?

DR. RITTER: Okay. I thought institutions were willing to pay soft dollars as a way of incentive, you know, giving knowledge to the analyst.

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MR. WEILD: Yeah, but a soft dollar -- I'll pay -- I'll pay you on a micro cap trade with a trade in IBM all day long for the research. It doesn't actually help the liquidity creation of the micro cap name. It may do that.

You know, I mean, guys are -- guys are -- you know, I don't trust you to do an execution on this micro cap name or whatever, so I'll go execute it through somebody who's my preferred trader, and I'll pay you with things that are totally irrelevant, totally different industry, you'll get those trades over your desk in soft dollars all the time. Right.

Dan?

MR. CHACE: Yeah. There's execution and less execution paid for that. But it's true, as David said, it's not always addressed. You add value on this side; therefore, you trade.

MR. WEILD: And institutions will sit there, and, you know, they'll go through what they call the broker vote and they'll decide, this is how much -- this is what we think our commission pie is going to look like, and this is how much we have to pay this firm, this is how much we have to pay this firm during the course of the year.

So the actual linkage is -- is not necessarily

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there. It's about the holistic relationship. And the trader has discretion on the desk to -- you know, he's just got to make sure that he gets a certain amount of commissions to that firm during the course of the year.

But how he does it is entirely up to him to get the best price execution for each of the funds that are under management.

Okay. Sorry.

MR. GRAHAM: David, this is all very interesting. It's great.

How much more time do you need?

MR. KIM: I need -- I need two more minutes, and then -- and then I'm done.

MR. WEILD: Then I want to get into recommendations.

MR. GRAHAM: Okay. So five, ten minutes?

MR. WEILD: Yeah, ten, give us ten.

MR. GRAHAM: Okay. Give you ten.

MR. KIM: We've covered this, but this is -- what the current level covers is only the cost of execution. We have lost the ability to cover the costs of the elements that were needed to create liquidity. So, you know, it's capital commitment, sales research, creating visibility. This is essentially an execution-only market now.

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In recent months, from a very broad cross-section of market practitioners, everyone from exchange specialists to academics to small investment banks, we've seen growing recognition of our assertion that increase in tick sizes is a viable and necessary way to go. Everyone from Duncan Niederauer with the New York Stock Exchange who has said on the record that they've been looking at this internally, and that it would be fairly easy to implement; Kevin Cronin, head of trading at Invesco; William O'Brien of Direct Edge; Jim Toes, the president of the Securities Traders Association.

We have -- at the Congressional Subcommittee hearing that David was at two months ago, we heard from a very broad cross-section of folks that all were in support, universally in support of at least a pilot study to explore what happens with tick sizes.

MR. WEILD: The Investment Company Institute that represents the mutual fund industry came out for it in Congress.

MR. KIM: So this is -- this will be our -- or my last line, and then I'll let David go.

If you look at all of the potential causes, and, again, bearing in mind that timeline that you saw before from when Reg ATS was first instituted,

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Sarbanes-Oxley -- we're not saying that Sarbanes-Oxley has no effect. Clearly it has effect, clearly it has a cost impact.

But based on two things: Based on the timing of Sarbanes, which was in 2002, and based on the actual amount of dollars involved, we think that the impact of Sarbanes-Oxley on the IPO market itself has actually been very small. And we also -- I absolutely respect Professor Ritter's studies and his thesis about economies of scope, but, again, I think the notion that small firms can create more profits by selling themselves to larger firms, a lot of that is technology driven, a lot of that I think is, as it relates to the IPO market itself, again, I think the -- I think the impact is very small.

The largest impact that we have seen boils down to the economics available for the intermediaries in the business, which are the investment banks and brokers, to create the support infrastructure that worked for decades in this market. For decades.

And the dire situation that we find ourselves in today I think is the inevitable consequence of the loss of the economic infrastructure. We are today exactly where we were destined to be once we sucked the economics out of the system.

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MR. WEILD: We had -- I'm just going to plow through these very quickly. This is about equity distribution infrastructure and how it's eroded. And, you know, there's -- every single bulge bracket, major bracket firm handling middle market institutional sales desks, they've all been shuttered.

The top 60 accounts represent about 90 percent of the top commission opportunity institutionally for firms. A lot of it is coming from the lending business, and prime brokerage is no longer even stocked. So if you want to get out -- if you want to see who's distributing to the smaller institutions, basically nobody. I mean, you can't -- there's about 3,000 institutions in the United States right now that have over a hundred million dollars.

And so Dan Chace is not getting an allocation on a new issue, even though he's a growth manager with $12 billion under -- under management for most of the time because he's not big enough to be covered effectively by Morgan Stanley. And actually, at $12 billion, he's -- there are a lot of institutions that are not getting allocations at $50 billion in assets under management. I mean, that's how big the cutoff is. And people are chasing the dollar.

We're going to go flip through --

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MR. KIM: The most active hedge funds pay investment banks in excess of a hundred million dollars a year in their total relationship. Stevie Cohen pays Goldman Sachs well over a hundred million dollars a year.

So your CEO, with a hundred million dollar IPO that's going to generate at best three million bucks, you're not the customer anymore, you're food, and that's the problem.

MR. WEILD: You know, you talked about this is trailing 30 IPOs, you know, and this is -- you know, one of the things that I do agree with Jay is that if these things are not supported and properly distributed, and they're not being priced on fundamentals because they're going to too many -- too many people that are not really focused on the fundamentals, they're renters, not owners to the stocks, we're seeing IPO success rates decline. And when people lose money, then the window shuts; you can't keep it open. It's pretty simple.

MR. KIM: And this is for large -- it's for larger deals as well. It's not just on small deals. IPO success rates on all deals of any size have declined.

MR. WEILD: So I -- and by the way, the SEC has been inundated with information mostly on the S&P

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500. And you can see how different these markets are. This is where the S&P 500 is, and this is where the Russell 2000 -- even the Russell 2000 has -- is -- is -- which people use as the small cap index, is bigger on average than where this dysfunction is occurring.

So, you know, you can't -- and by the way, a lot of the data on the Russell 2000 says that spreads haven't come in. So you can imagine, a lot of them in the micro cap/nano cap may have even -- even -- even widened. I don't know, I haven't seen any analysis on that.

But that certainly is the trend line. You can see this is the market value of these stocks. The number of stocks are all clustered down at the bottom, and -- and -- and this is the market value up here.

And as you can see, these stocks down where capital formation lives are totally different because they represent only 6.6 percent of market value spread across -- spread across a large 81 -- -1.1 percent of all publicly listed companies.

So just right into recommendations. And what we've been able to, you know, surmise, we think that you need to do mass customization of tick sizes because one size doesn't fit all. And there's a lot of people that would argue if you could have even small tick sizes in

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S&P 500 stocks. And the question is: Do you want to proliferate gaming and stepping ahead and those kinds of behaviors?

But at the end of the day, the downside is probably not great for the market. But where it is, is that you need higher tick sizes to support small caps.

And every stock is different. The mini micros, the nano caps are going to require higher tick sizes than a -- than a micro and than a small cap stock, so on and so forth.

Then the question is: How do you create a system where the market can determine tick sizes?

Well, there's two methodologies here that could work that we've come up with, one of which was from conversation we had with stock exchanges, and one which was ours, which Professor Angel has endorsed, which is allow issuers to choose their tick size after consultation, if you will, with institutional investors and with Wall Street firms. Because what you're trying to do is figure out, how do I get people to pay attention? Okay. And so if you have a lever, maybe that's within some tolerance, zero to 5 percent of the share price.

The other one is to try and think about doing it algorithmically. And you can use the algorithmic

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methodology as a default, which basically says, here's the spread for the last year, and we're going to make spread equivalent to tick size, which creates a bankable spread, converts a quoted spread to a bankable spread.

So if it's -- the market has also already sort of determined that the average trading spread is a dime, then make that the tick size. It's pretty simple. Because nobody can monetize it anyway. So at least you create value by incentivising investors to -- market makers and others to kind of go after that spread.

So those are the two concepts. This is the -- you know, how the range would work on share prices so, you know, the SEC could oversee this.

And then here's -- you know, here's just the basic math of the algorithm. It's pretty darn simple; it would be pretty simple to implement across the market.

And -- and then finally, with -- you know, these are some -- this was something that was socialized at NIRI, National Investor Relations Institute, which is just an issuer bill of rights which -- that we think that issuers and issuer advocates need to have an equal voice in stock market structure. And sometimes we think that the traders inundate the trading interest, inundate the Division of Trading and Markets. I've said this to

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Chairman Schapiro, by the way, probably about a year ago.

And so I would like to see Gerry Laporte's group, which represents small companies, represented in, you know, an equivalent kind of structure in the Division of Trading and Markets, because I think you guys are confined to Corporation Finance, if I'm not mistaken.

At any rate, I may be wrong about that, but it just appears outwardly that when you take Reg ATS and Reg NMS and you proliferate lots of stock exchanges that don't represent any issuer interest -- there's only two, NASDAQ and then New York, and there's about 13 exchanges in total and all sorts of Reg ATS -- that you're going to have lots of trading-only interests that are lobbying the SEC and Congress for things that are really beneficial to electronic execution and trading and not necessarily in the best interest of issuers. It's just -- you know, it's outsize representation.

We'd like to create greater transparency, timeliness, and completeness in terms of share -- share ownership. And there's no reason why people shouldn't be able to understand who's shorting their stock.

I get very, very fit to be tied when I see issuers wasting tons of time being dragged around to see hedge funds and other people that are doing damage to

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their stock when they should be back in the office running their business.

And because the lack of transparency on this information -- by the way, you have insider trading issues you'd have to control around, but they really should have real-time information. Every CEO deserves that, in my judgment.

Choice in market structure. Again, no more one size fits all. You can do it with sort of the -- lots of things that you can do. But we are now a country with one tick size and one market structure all homogenized because of Regulation National Market System. And that is a lot of systemic risk. We bet everything on black here. We have no choice.

And then finally market structures that encourage fundamental investing over training. This is a very trading-centric market.

And we need to get people back to basics. We need -- we need firms like Wasatch -- I don't want to pick on you, Dan, but these are the firms that are going to lead us going forward and going to allocate capital efficiently in the marketplaces. And we need -- we need -- we need market structures that favor fundamental investors like the Wasatches, the AllianceBernsteins of the world, and not trading centric hedge funds that are

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long shorts, where -- where the idea of a long-term hold is buy it on the open and sell it on the close.

MS. HANLEY: Great. Thank you. I have just one question as we go through this.

So I'm hearing from you that there are a certain amount of profitability from the investment banking side or the trading side that should be earned in the market, and that these changes, regulation changes that we have done has taken away rent from investment bankers and given them essentially to investors. They're trading at too low a price and then investment bankers can no longer make any money.

So you want to swing the pendulum, I understand, back to sort of more of the middle ground where those rents can be split perhaps more evenly.

Do you have some idea of what is the appropriate split, so to speak? What is the -- if -- when we -- if we were to change tick sizes, how do we quantify where that tick size should be that we now have a better understanding of, you know, how much should go to the market maker vis-a-vis how much should be going to the investor? Do you have a sense of how we would measure that?

MR. WEILD: I think that, you know, the market to some degree, I think, Kathleen, is already -- already

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telling you a little bit where the spreads are. I think that the spread is a pretty good indicia. If it's sitting there on average over time at 20 cents, I mean, that's probably -- you know, it's not doing -- it's not creating any value for anybody. Make the spread, you know, 20 cents.

You could look at how the quote-driven market actually occurred before the IPO dysfunction, you know, happened in 1998.

And for a long time, we had two ticks per quarter point. Right? It was an 1/8 -- it was a 1/8 tick. And it allowed institutions, if you will, to -- for the most part, to trade within this spread.

And so you could, you know -- you could play -- I mean, if I was going to do it, I would probably sit there and say, take the spread, do one sample set at a -- at a -- at -- where the tick is equal to the natural spread. And I would take another sample set and maybe experiment with, you know, two ticks or three ticks and see what happened.

The problem is you're going to get -- if you do a pilot study around that, you're going to get short-term interest. But the real hard-core, long-term investments and people resources are not going to accelerate until people know that the pilot is --

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MS. HANLEY: Yeah, that -- well, that -- that is definitely a challenge with the pilot.

And more importantly, I think it's important that we get the number right so that the incentives occur, right?

MR. WEILD: Right.

MS. HANLEY: If we set the tick sizes too small, again, we'll be in the same realm.

MR. WEILD: But --

MS. HANLEY: If we set it too large, we'll drive away investors. And so we don't need to answer it here --

MR. WEILD: But -- but --

MS. HANLEY: -- but as an advisory committee and as the --

MR. WEILD: Well --

MS. HANLEY: -- roundtable will occur, I think it's important that we think--

MR. WEILD: But we also said, you know, why not let -- why not let issuers choose? Because I think that at some point they're going to get beat -- they want to get interest, they're going to get beaten up by, you know, Wasatch.

I mean, they're not going to be -- they're not going to be coy. They're going to say the tick size is

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too high. The bankers are going to say the tick size is too low.

At some point, people have to come up -- by the way, it would put -- it would cause issuers to finally take an interest in market structure and how it impacts, you know, their -- their stock prices.

And so there are some problems; you know, everybody is uncomfortable with the idea. But the fact of the matter is that one tick size doesn't fit all.

And a chemical stock with a hundred million dollar flow, for the sake of argument, is going to trade -- has a very different ecosystem than a “SaaS” stock, a software as a services company. There's a lot more research analysts, if you will, naturally around SaaS as an industry than there are -- and market participants, than they are necessarily around certain small cap chemical stocks. And so -- so the answer is going to be different for them.

So whether that -- you take the natural spread and set it equivalent to the tick size, you let issuers -- you get -- you get to -- you get to a model which is mass customization of tick size, which I think is the right answer.

MR. GRAHAM: Okay. Well, thank you. Thank you again, David.

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Lona, do you want to go into JOBS Act?

MR. NALLENGARA: Sure. I think I can update on what's happened since our last meeting with respect to the JOBS Act.

One of the larger events was our proposing release of Title II. Title II is the general solicitation. We talked about it at a couple of meetings.

There was a provision in the JOBS Act that would remove the restriction on general advertising in Rule 506 offerings. These are private placements. Under Rule 506, currently you cannot advertise, you can't have newspaper ads, you can't have an open access website. Title II would now permit you to do that if you only sold securities to accredited investors.

And in the JOBS Act, they added an additional provision to that that requires an issuer to take steps to verify that who they're actually selling to are accredited investors.

It's somewhat straightforward to remove the restriction on general solicitation. It's a little more challenging outlining what those procedures are for an issuer to take to verify who your accredited investor is.

If you're an institution, if you're a

broker-dealer, showing or -- or providing an issuer with some verification that you are -- rather, an accredited investor, it's likely to be straightforward.

But if you're an individual, providing support that you are an accredited investor could be more challenging. There's a net income test, there's a net worth test.

So when this provision was included in the JOBS Act and enacted, people were asking questions on how would you go about and -- and -- how would an issuer verify that someone is an accredited investor or not? Would they need a W-2? Would they need to get -- would they need to see tax returns? Would they need to have bank statements? How would an issuer know that they were selling to an accredited investor? So that's what we were left with in connection with the rulemaking.

And the proposal that came out last week creates a -- creates a framework where an issuer has to look at the facts and circumstances of the transaction. How are they finding their -- how are they finding the purchaser of their securities? Are they -- are these long-time holders of their securities? Are broker-dealers providing them with the connection with those -- with those purchasers, or are these individuals that they're finding because they are clicking a page on

their website that says buy securities. So that's one part of the package in this analysis.

You could also look at, what are the terms of the offering? Is there a minimum investment amount? Is the amount that a purchaser is required to buy high enough that you are -- that that's a fact you can look at to determine that that person is a person who's an accredited investor? If there's a $5 million minimum investment amount,it's not hard to make an assessment that that person may have a net worth in excess of -- in excess of a million dollars.

So we – in the proposing release, the Commission made clear that they weren't identifying specific procedures that you had to do in a particular circumstance. But rather, look at your -- asking issuers to look at the facts and circumstances of the transaction and make an assessment of what are -- what would be appropriate, given what you know about the purchaser, how you found the purchaser, and the nature of the transaction. Take those steps and make an assessment of what needs to be done.

So that's, in a nutshell, the proposal.

One additional part of the proposal is that there is a Form D requirement for when you complete a 506 offering. You are supposed to file a Form D.

What we've proposed to include is a box that you check on the form that would indicate that you are -- you, as part of the offering, you generally solicited or not. This is a way for us to be able to track, identify which offerings, which market participants have been participating in offerings where there's general solicitation.

So we can go back and look, after the rules are adopted, to see what procedures are being used, is the framework that we've set up one that works, and be able to look at the market more generally.

So that's the proposal. There's a 30-day comment period. We expect, as there was in the comments before we proposed the rule, we expect there would be a wide range of views. Many people have indicated that they're -- that they like the proposal. And as you can imagine, there are alot of people who said they don't agree with the proposal. So we're hoping to hear from everyone on that.

I'm not sure if anyone has any questions on the proposal.

MR. WALSH: What are some of the reasons against it?

MR. NALLENGARA: Well, some of the reasons are that there should be more definitive requirements. Some

are saying there should be more definitive requirements. You should be -- you should be -- there should be more onus on an issuer who's doing a general solicitation deal to have more third-party information, documented information. So there are -- I think there are probably letters on our site that indicate that the issuer should be getting some third-party information to support whether an issuer -- whether a purchaser is actually an accredited investor.

MR. WALSH: W-2s.

MR. NALLENGARA: W-2s. And there are letters on the other side saying that would grind -- that would grind the 506 offering to a halt, that people just wouldn't -- I mean, if I'm -- if I'm -- I wouldn't want -- you know, it's one thing to provide information to a broker-dealer. I'd be more comfortable, some of the comments are saying, I'm comfortable giving that information to a broker-dealer. But if this provision is designed to allow issuers to access the market without a broker-dealer if they don't want to, if they want to access it on their own, am I -- is a person going to be willing to provide that information just to the issuer that they've never met before? They have no idea, there's certain kind of privacy rights concerns.

So there's other comments indicated that if
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you're going to allow for general solicitation, there's lots more stuff you should be looking at.

The definition of accredited investor, many people have said for a long time that definition is an old definition. You shouldn't just be looking at net worth, you shouldn't just be looking at income. You should be looking at investment. How much money do you have invested in private securities? Is that a better test?

And there's Dodd-Frank, which tasked the GAO to do studies that will be coming in the next year that would look at the accredited investor definition broadly.

So what the -- what the Chairman's statement at the time of the proposal was, there's lots of stuff within the 506 market, specifically about Reg D generally, that needs to be looked at. The definition. And the form itself, the one where we propose having a box checked.

There's lots more information we could ask for. We could ask for -- you know, we could -- we -- a lot of information could be drawn from that that would help us understand what the market is like. All of that is, you know, subject to review.

But the terms was Title II requirement, what
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Congress asked us to do was a narrow one, so we focused just on that narrow part. So other -- I'm sorry.

MS. MOTT: I have a question.

MR. NALLENGARA: Yes.

MS. MOTT: I can see where in a case where a company that's raising -- a startup company that's raising money, the ruling can apply to both.

You know, if they're going to give it to a crowd funding issuer, you know, obviously because you can't tax -- to answer your question, it can bring and attract people who might not be accredited. So you really have to find a way they are accredited.

But let's say they're going to generally advertise through this issuer who's online or whatever else, but then doesn't raise enough money, now has to come to, you know, the angel group, let's say, who, by the way, aren't going to give the entrepreneur who's coming to them their information, you know, their tax returns, their, you know, net worth statements, things like that.

So in this case, we have the ruling applying over here, but maybe all of a sudden now they're not going -- not going to -- it's not general advertising or it is because it's accredited investors who have invested in, you know, these types of companies before.

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I mean, I guess I'm a little confused by it.

MR. NALLENGARA: I think -- what you're asking is --

MS. MOTT: Am I asking? I don't have --

MR. NALLENGARA: If you start an offering as a general offering, is that --

MS. MOTT: That's it.

MR. NALLENGARA: Well, there's a lot of questions on it. We have a number of rules related to -- related to integrating an offering, whether if you generally solicit in an offering and then continue, can you -- for example, you know, real quick, the rule proposal keeps intact the current Rule 507.

If you want to do your regular way 506 offering where you're not -- you're using a broker, you're using your existing investors, you don't necessarily have to -- you don't have to go through -- you don't have to look at this new proposal for the final rule. You can continue to use your established procedures.

If you want to generally solicit, that means if you want to have newspaper ads, if you want have a website, then you need to look at the verification standard.

What the practices are now currently may

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already satisfy that verification. A lot of companies that are doing current practice 506 offerings are using practices that are -- that would be consistent with this verification model.

So if a company starts an offering by way of -- by way of a general solicitation, and they want to move back to a sort of regular 506 offering, what they're going to have to look at is they're going to have to look -- it's not as easy as saying, yes, they can do it. They're going to have to look at what general solicitation activities they're going to do and whether that -- whether general solicitation is in fact how your folks for the angel network have been attracted.

But I would gather that there's probably methods by which your network could establish accreditation levels for members that would satisfy the requirement.

The rule proposal suggests there will likely be third parties that will develop -- that will accredit investors. So SecondMarket has indicated that they -- this is an area that they'd like to work in as being a repository of accredited investors. So you could get -- you know, you could get the SecondMarket stance that would say this person is an accredited investor. We've looked at their -- you know, we've looked at their information.

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They were -- and -- and an investor may be more comfortable providing information to a known entity, whether it's an angel investor or whether it's SecondMarket or some other third party. It would be a way which -- you don't necessarily have to provide that information to the issuer.

MS. SMITH: So the company sells shares based on the representation certified by the third-party but it turns out that the person is a non-accredited investor where -- is there a violation of that rule? Is there going to be a filing rule?

MR. NALLENGARA: That's a great question, Karen. The current rule, as well as the proposal, has a reasonable belief standard on it. So if you've taken steps to verify, and the person -- and the person -- let's say they went through a third party, and the third party is documenting the procedures they go through in establishing whether someone is an accredited investor, and they certify to the issuer that we've checked -- we've checked Karen Smith, and we've gone through what our normal procedures are, and Karen Smith is an accredited investor. And I rely on that information, and we find out that you doctored, you gave a fake tax return, I still have a good -- I still have a good 506. It's sort of reasonable for me to rely on this third-party

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established procedure. I wouldn't lose my 506.

Actually, there are a number of cases where individuals who have -- who have faked their accredited investor status, have purchased securities, then wanted to rescind the transaction because they weren't an accredited investor. And they have been unsuccessful. So I'm not sure that was a plan of yours.

MS. SMITH: No, not a plan.

MR. NALLENGARA: I think we're at 12:00. We have -- for the members we have lunch. And Marc -- I think I saw Marc. Marc Fagel, who's the head of our San Francisco office, was going to talk to everyone about some areas of interest to small companies unrelated to both topics today, but we thought it would be interesting for all of you to hear that.

Steve, you want to take ten minutes while we

get lunch together, and then we'll reconvene? I think Marc will speak for about 15 minutes, and then we'll -- and then I guess sort of have free time back until 1:00.
MR. GRAHAM: Perfect.
MR. NALLENGARA: Okay.
MR. GRAHAM: Let's do it.
MR. NALLENGARA: Sorry. So if you wanted -- the security is a little different than our meetings in headquarters. So you're obviously allowed to leave and

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we'll all -- and we'll let you back in. But it's a little more challenging to get back into the building than it is at Headquarters. So I guess for the members, we're going to reconvene in about ten minutes, lunch, and then Marc will speak. And then if you want to leave, you just have to -- you have to come back closer to 1:00. Come back to the 28th floor, and we'll bring you all back down again.
For those in the public who want to leave and come back at 1:00, if you can just come back at ten minutes to 1:00, go back to the 28th floor, then we'll come and get you and bring you back down.
MS. ZEPRALKA: If any members of the public are leaving and not coming back for the afternoon session, please hand me your lanyards on the way out.
MR. GRAHAM: Great.
MR. NALLENGARA: Back in ten minutes.
(Whereupon, at 12:01 p.m., a luncheon recess was taken.)
A F T E R N O O N S E S S I O N
(12:23 p.m.)
MR. GRAHAM: Committee members, time for noontime program. And as I think you know, Marc Fagel -- I guess you're based in San Francisco -- has agreed to spend some time with us talking about some of the -- some of the important issues, I understand, the effect on smaller companies.

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I think we're going to hear a little bit about -- more about the traffic is going to get worse and essentially how to keep out of trouble. And kind of stay in the terms of time.
MR. FAGEL: Well, thank you. Yes, so my name is Marc Fagel. I'm the Regional Director of this office, and I welcome all of you to our new facility. Hopefully things are working -- working well.
We've got about just over 100 folks out here, about half of whom do enforcement, the other half are examiners and broker-dealers and advisors in funds and the like.
But I'm here to talk about enforcement. And we just thought it would be nice to throw in a little breather during the program and talk about how to really avoid you ever having to be back in this office again.

So before I do that, I do have the standard disclaimer that I'm sure my peers agree, which is that the opinions I'm going to share with you are my own. I don't speak on behalf of the Commission or the Commissioners.

But I want to talk a little about some of the high priority areas and the sorts of enforcement matters that come to our attention that involve newly public companies or emerging companies.

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The -- you know, not surprisingly, one of the top priorities, certainly for this office, but nationally, has long been financial accounting fraud by public companies. And in this office in particular, we're responsible for Silicon Valley, Seattle, Portland. We have a lot of tech companies, biotech companies that are emerging with their own set of accounting issues.

And dating back, I've been here about 15 years, and, as far as I can remember, that's always been our number one component of our -- of our docket. And traditionally, it could be a quarter, up to a third of the cases we do in our office involve accounting or disclosure issues with public companies.

The piece of good news for the folks in the room is that that is way down. And for the last fiscal year, SEC-wide, only about 15 percent of the enforcement matters we brought involved accounting and disclosure matters for public companies.

And I can't tell you exactly why that is. Personally, my belief is that a lot of that has to do with Sarbanes-Oxley. And I know that certainly for those of you in the room and in the industry, there are a lot of concerns with Sarbanes-Oxley and the costs. All I can tell you is that the number of restatements and the number of enforcement matters has gone way down in

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the last decade.

Now, some of that is also just going to be the post-Enron, WorldCom environment where I think companies got a little more careful. I think auditors became much more aggressive, I think boards were more engaged. I think that has no doubt helped quite a bit.

I do, unfortunately, have a cynical view that a lot of people have short memories, so I wouldn't be surprised to see that number starting to go back up, certainly as the economy improves.

And once again, there's the expectation for companies to reporting -- to be reporting great revenue numbers. I think that's when games start getting played.

The piece of bad news I have to share is that to the extent that we do continue to see accounting fraud cases coming out of our office and nationally, a lot of those do tend to be with smaller, newly public companies. I think the quality of internal controls is not quite the same with -- as with an established company. We do see a lot of companies that go public before they necessarily have the mechanisms in place, the internal controls they need to prevent the sort of recurring financial accounting issues we've seen.

So some of the classic cases, last day of the quarter, you're not making your numbers, your salesmen

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are calling all their favorite customers and saying, I know you don't need the product today, maybe six months from now, but let me ship it to you; you don't have to pay, we'll work something out tomorrow, and don't tell our CFO, continues to happens, continues to happens, especially with smaller companies. Tends to happen more frequently I think, at least anecdotally, with companies with offshore operations.

So even companies that may have the HQ here in San Jose doing a bang-up job with their internal controls may not have the same focus on what's going on in Singapore.

So to the extent there are ongoing financial cases, you know, small companies do need to make sure that they have the appropriate controls, training for their sales staff and finance staff on what is appropriate, what is not.

And the top-down pressure always matters. And if you have the CEO and the CFO sending out those e-mails on the last week of the quarter saying, make your numbers or you may be looking for work, you cannot be surprised when games get played to help make those numbers.

The -- the other change I've noticed in recent years, in addition to the general decline of these

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cases, is that to the extent we do continue to see cases, it tends to be less in the revenue area. Historically, it was always revenue. The analyst wanted to see revenue growth, and that's where a lot of the tricks were being played.

These days, I think analysts are a little more attuned to that, companies are a little more careful there, but you do continue to see games being played with earnings management.

So the inventory numbers, for example, make your margins look better, make your expenses look lower. So you do continue to see that sort of matter.

Another area where we have a lot of focus in enforcement is, no surprise, the Foreign Corrupt Practices Act, or the FCPA. This has definitely been an area of huge growth for enforcement. You look back in the past couple decades that that statute has been in existence, and there were very few cases.

It's now -- we're actually breaking out statistics on that as a separate area because it's become so prevalent for enforcement interest. About three percent of our enforcement actions last year involved FCPA violations, improper payments to foreign officials in order to secure business. three percent --

MR. GRAHAM: Marc?

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MR. FAGEL: I'm sorry?

MR. GRAHAM: Where there's kind of a hair trigger or are people, in other words, being surprised because they think what they're doing is perfectly normal? I should take that back. It could be normal in that context, but you know what I mean.

MR. FAGEL: You know, I'm not sure how to characterize it. You know, as an enforcement attorney, I'm always looking for evidence of scienter. You know, it's not, you know, no one had a clue this was going on, we're shocked. That can still be a violation.

But the cases that tend to be more attractive if we're going to have to litigate them are those that have the terrific e-mail where somebody says, don't put this in another e-mail. That happens. There are a lot of e-mails, that is a search term when we are looking at e-mails.

So, you know, I can't pretend that there are a significant number of cases where there is obvious knowledge of what's going on at headquarters. You know, you don't -- do not typically have the CFO who says, I'm going to ship you a box of cash so you can get customers.

More frequently you'll see very, again, lax controls, where you'll have offshore operations where

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they are, for example, asking for tens or hundreds of thousands of dollars for a travel budget and no one back in the home office is paying attention that training is being secured for their new customers at Disney World.

You know, so, again, it's more, are you not noticing what's going on? Are you not asking the right questions? Why are we spending so much to run the small operation? And coincidentally, we just got a great government contract out of there and we're flying all these people here for a supposed training in Orlando.

So, you know, I think that the internal control issue is a significant one. You really do have to be on top of your offshore operations. What are they doing? How are they securing contracts? How are they accounting for their expenses? Are there slush funds being created so that cash or gifts or other rewards can be made to customers or to distributors who are helping to secure the foreign business?

And, again, this is the sort of situation where smaller companies are particularly ripe for this abuse because they may not have the controls. They're growing rapidly. There are mergers happening with offshore operations where they may not have the same controls in place to make sure that they're keeping an eye on these sorts of payments.

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The bigger problem with FCPA, of course, is that it gets tremendous criminal interest. Now, all the securities laws can be enforced criminally, but the FCPA is one area in particular where the Department of Justice finds them hugely interesting.

So in a typical SEC investigation into bribery payments, there will most likely be a parallel criminal investigation. We'll work closely with the Department of Justice. And, obviously, the penalties are much greater. It's one thing to be paying a fine to the SEC; it's another thing for your executives to risk incarceration. So the stakes are very high and the costs are very high.

Once one of these things arises, you're talking about doing internal investigation and dealing with a government investigation where all the activity is offshore. And once you have paid a large firm to send a large number of partners and associates to China for six months, those bills rack up very, very quickly.

So the stakes are very high; very important to make sure that you’ve got internal compliance down and you've got training to prevent this problem before it arises.

MR. GRAHAM: How often does incarceration occur?

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MR. FAGEL: I don't think it happens very often. I think the mere threat of it is enough to avoid the issues.

And like I said, it is pretty rare where you will see the scienter evidence arise to a level where you can show a senior executive actually knew or ordered this to happen. But it's not without precedent.

And I think one of the bigger threats, it's not so much our authorities, when you're dealing with foreign executives and you're dealing with the foreign government who learns about corruption, and they've got to deal with their own political situation when it comes to light that members of the government are receiving bribes, they may have a different approach to how they deal with executives there.

MS. JACOBS: Marc, how do you feel about self-reporting?

MR. FAGEL: It's a great question, and something I was exactly going to talk about. I'll talk about it now.

MS. JACOBS: Oh, I'm to go --

MR. FAGEL: I think it is -- I think it's essential. And I think it can make all the difference in the world in the outcome of an investigation, when there

is a -- is self-reporting. But let me circle back to
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that and talk about it. It's a great question.

Let me hit on two more quick areas on public companies and then turn to a couple short ones on private companies.

Two additional areas of interest for public companies, Reg FD, fair disclosure. It's a regulation, been in place about ten years or so. There were a few cases right off the bat when we brought it, then it was quiet. Now there's a bit of a comeback. There have been a few cases.

Essentially for those of you not familiar with it, it is a regulation geared at selective disclosure of non-public information to deal with the concern among investors that some companies are reaching out to favored analysts, favored institutional investors, and giving them a bit of a heads-up of some good news or bad news that's not quite out there in the public eye yet.

And we continue to see cases. And there have been a number of investigations in the last couple years, some of which have resulted in enforcement actions, where you do see senior executives, you see the CFO going home on a Saturday after reading what the analysts are saying and making one-on-one phone calls to a few analysts to talk them down off their numbers. Some pretty -- some pretty blatant abuses out there.
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I think when the regulation was first passed, there were concerns that, well, what if -- what if someone has body language during an earnings call and everyone picks up on it, is that unfair?

If you look at the cases that have been brought, it's not body language. There are, unfortunately, some corporate executives who will go out there to a hedge fund who has made some general advances in the past and actually pick up the phone and call them and say, you know, your numbers aren't quite right.

So the calls I think that we've made have definitely been cases where people would agree has been a violation of selective disclosure.

And then the last area that's of perennial interest to us in Enforcement is insider trading. And a lot of these cases are very high profile. The playing field here has really changed in the last few years for the SEC and certainly for the criminal authorities who pay attention.

Historically, you'll see basically one-off situations. An executive, a director, an employee who learned something non-public about the company and trades on it or tips.

What you've seen changing in the last couple years are large-scale trading rings, systematic trading
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where you see networks of individuals who provide information, say, to hedge funds reaching out to employees of multiple public companies and systematically obtain non-public information, allowing investors to make millions of dollars.

These cases, you know, the repercussions are huge. They have gotten much criminal interest. You have wire taps involved, which really changed the degree and nature of the investigation. Fascinating cases, and not the sort of thing any public company wants to get involved in.

Now, the repercussions tend to be for those individuals who are trading and tipping, not necessarily for the company itself. But again, there are huge resource costs.

And if the SEC comes calling and next thing you know you've got a senior executive or a member of your board who's wrapped up in an SEC investigation, that can have some serious implications for the future of that individual at your company.

So it's definitely, again, worth -- you know, I say it over and over, make sure you got the internal controls in place. Make sure that any non-public information is disseminated only to those who need to know and at the last possible moment to reduce the risk

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of that leaking out.

The other piece of advice I have to give you, especially if you are involved with a newly public company, is the importance of a trading plan. There is an SEC rule that provides for presumption, that if somebody who is trading pursuant to a regular trading plan is not trading on the basis of non-public information.

So if your executives have received a large amount of stock, which has value once the company goes public, and get on a trading plan, so that the first day after every earnings announcement every quarter, X percent of the portfolio is liquidated, it makes it very hard for us to get interested.

When we see that a CFO made a very large sale the day before an announcement, we will make a phone call and ask about that trade. If we get a copy of the trading plan that says, well, we trade on that day of that month every single month, and we've done that for three years, that's probably the last you'll hear from us.

So I can't emphasize about the importance of having a trading plan. And following it. The trading plan doesn't do much good if you don't follow it, or if your trading plan is that I will trade a lot of stock

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the day after, the day before really good news and -- that's not going to work.

But if it's -- if it's a legitimate plan that is followed that's objective and it really takes away the element of trying to capitalize on nonpublic information, it's an excellent idea.

And then, finally, I wanted to hit on two issues that come up with companies that are not yet public that tend to be repeat players in our office.

Private companies out there financing through private offerings that are playing fast and loose with the facts. You know, the number of fraud cases, it's an ongoing area for our interest when you've got false statements being made in connection with private offerings.

Most importantly are representations about how the money is going to be used, the proceeds are going to be used, especially if the money is going into the pockets of the individuals running the company. It very quickly begins to look like misappropriation if there is a disclosure about a certain compensation structure that will be used, but most of the funds, the offering proceeds are going into the pocket of the executives or they're getting large loans that may never be repaid. So representations about what is going to happen with the

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proceeds of the offering are going to get our attention.

We said we repeatedly see instances of playing fast and loose with the background, whether educational, employment background of the principals of the company. Going to attend a seminar one day does not make you a Harvard graduate.

You see, you know, overselling of the prospects of the product or service that the company sells; revenue projections that have absolutely no basis in reality. Again, just because you're in telecom space does not mean that you can have the same projections as Apple does for the iPhone.

Similarly, talking about your business prospect, your business partnerships has to be honest. And again, you know, the fact that you carry an iPhone does not mean that Apple is a strategic partner of your company.

So the things that people will say are crazy. And it's, again, not very difficult for us to disprove a lot of the representations we see.

Yes, sir.

MR. WALSH: When you mentioned right before about the private placement, do you find a lot of -- more issues with private placement than debt, issuing debt as opposed to friends and family trying to raise

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some money (inaudible)?

MR. FAGEL: I would say that, you know, frankly, where we most frequently see it are in equity securities offerings by small companies, which sometimes start to appear very quickly to be more akin to a Ponzi scheme. So a company that is out there with what they call a private offering, what I think you would do is more public offering.

You start having seminars when you reach out to family and friends, and have them share your prospectus with everybody they know. And very quickly, you've got hundreds of people that you've never met sending you money for stock. Those tend to be, you know, where this arises.

And again, you know, we are -- there's no secret that we have very limited resources at the Commission. So to get our attention, we really do have to be doing an analysis of: Is this something that we've got the resources, the time, and the manpower to take a look at?

So if you're raising a small amount of money from a small number of people, even if there is out-and-out fraud, it may just not be something we're able to deal with. It may result in a referral to a state agency or a district attorney, for example. But

the wider, the broader, and the more successful the offering, the more likely we're going to focus on it.

And then the last area I touched on are -- and hopefully this isn't something that happens too prevalently with the folks in the room, but companies that choose to go public through a reverse merger with a shell. There are companies that can do that legitimately.

I'm not here to disparage whether or not that is an appropriate way of going public, but I do have to say a large number of market manipulation investigations come from what may be at one point legitimate private companies that seek to create liquidity through a reverse merger.

And any time the mechanism for going public results in a large proportion of the non-restricted shares being held by a stock promoter or people closely affiliated with the company, I do think that there is a large risk of that company having its stock manipulated for personal gain.

And those cases are just -- you know, it's a deluge. They come in day after day, a small company, public through a reverse merger, you see the spam, you see the fax go out, the stock goes from a quarter to 50 cents, which doesn't get a lot of our attention, but the

stock promoter can make a few million dollars over the course of a weekend through one of these fax campaigns.

Turning from these areas to a couple of ways to -- other things for you to be thinking about. One of the major changes in recent years has been the change in our law on whistleblowers under Dodd-Frank. And this is a very new phenomenon where the Commission now has a mechanism and the ability and an incentive to pay cash to individuals who refer information to us that allow us to successfully investigate and prosecute a fraud.

This is something that was on the mind of Congress at the time of passage of Dodd-Frank to make sure that individuals had an incentive to come forward with useful information to the SEC and to make sure we had at the staff level an ability to process that and reward that information, which really changes the nature of the game.

The number of referrals and complaints we get at the SEC is astronomical. But when there is a price tag and incentive for somebody to give us information that may actually allow them to reap millions of dollars, the numbers can be quite large.

The quality of information can go up quite a bit, and the incentives for people who have really meaningful information can go up. You know, I can't

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tell you how many e-mails we get from somebody saying, my broker is crooked, can you take a look at him? That's of limited use.

It's another story if you've got somebody who is a current employee of a company saying, I think our CFO is doing something inappropriate; here's some e-mails, here's some documents I've got, and sign me up because if you successfully investigate this, I'd like to get 10 to 30 percent of any recovery, quality of information is different and the incentive for a current employee to get involved and come to the SEC has really been ratcheted up.

It's still a relatively new program. The very first award under the program was made recently.

Looking back at some of the areas I mentioned before, you take, for example, a Foreign Corrupt Practices Act case where you may have a $10 million penalty, where we have the ability under Dodd-Frank to give 10 to 30 percent back, you've got somebody with an incentive who can make $3 million by giving us some documents showing us that a bribe has been paid.

You know, it's a real incentive maybe for your employees, maybe for your competitors who are feeling a little aggrieved that they did not get the business you got to come to the SEC and say, I've been talking with

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that distributor, and I can tell you exactly why they made the sale and we didn't; and it's because ABC did XYZ.

So we do have regular daily calls coming in from people with valuable information. So, you know, for all of you who are -- who are out there, you do need to be thinking about, what are the employees doing? If they are coming forward to company management or the board with information, that you're taking it seriously, because if you're not, it's pretty likely that they're talking to the SEC.

Which brings me to the last issue, which is -- which is something that you raised, which is self-reporting.

You know, given that there are more whistle-blowers who are coming to us, the question is, if the information is coming to the company itself as well, what is the company doing? Is the company coming to the SEC?

Now, for the past decade or so, we have tried to make it very clear within Enforcement that we do have an expectation for companies to self-report issues to the Division of Enforcement, to work with us to assist in our investigations, and that there are material differences in the results of any investigation

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depending on the level of cooperation that we receive from the company.

So, you know, a company that comes -- and this happens all the time. You know, they'll call me or they'll call our head of Enforcement and say, our auditors came across something unusual, we're conducting an internal investigation, we would like to come to your office and share the information, share some documents, talk about what we learn through our interviews of some of our employees. That is something that is looked upon pretty favorably.

A company that decides to wait to see how it works out, and the first we hear of it is because a whistleblower comes and calls us up and says, you know, this whole thing is going on with the company and you don't know about it or we read about it in the paper or the company announces a restatement, which is news to us, we're already wondering, is this company going to ultimately want to do the right thing when they weren't even talking to us about it?

So it is very important for companies to think seriously about reaching out to Enforcement, giving us a heads-up and sharing information.

And, you know, I know that there's a serious calculation among defense counsel about whether or not

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to do that.

I come back to what I said earlier about our limited resources. If a company calls me up and says, we've got an issue, we're taking a look at it, can we come in in a month or two when we're done with our internal investigation and share the information, it's going to mean I can sit back and not be sending out subpoenas, not be forcing my staff to cut up an otherwise busy day to run out and start talking to witnesses. That is good for me and would be something we'd want to be thinking about later on in deciding what to do with a company if there is a problem.

If it turns out there is no problem and the company comes and we've got a basis to believe that they're shooting straight, sharing information, and it turns out that there's nothing there of interest, we probably are going to go away. We've got better things to do. I've got a million other cases that we can be investigating.

So I think there's a perception of a major downside of fronting the issue for us, but if it turns out to be nothing, we've got other things to do; if it turns out to be something, I think the company benefits by giving us a heads-up and working with us.

I think to the extent there's a perception

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that if the company doesn't share the information and hopes for the best it's going to work out, I don't think that's right. If we read about a restatement and the company is saying, well, send us subpoenas and you'll learn what you learn, we're going to send those subpoenas. You may, you know, have about 30 executives spending, you know, a lot of days in this room being questioned because we don't know what's going on and we're trying to figure out what happened. We're going to be asking for an awful lot of documents because we need to figure out for ourselves what went wrong.

In contrast, if independent counsel, forensic experts hired by the company come in, make a presentation to us, and say, here's what we've looked at, here's five individuals who you need to talk to, these are the top people involved. These five people know nothing, we've talked to them. Here are the key documents that are going to help you make a decision, it's going to allow us to narrow our investigation.

Again, we don't have the resources or the inclination to look under every rock. If we can understand from the company and believe we're getting fair information on what might be out there, we've got every incentive in the world to focus our investigation, to wrap things up quickly, and then to look favorably

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about the company when we're trying to decide what -- how to resolve it.

So that's what -- what I wanted to share with all of you. Happy to take any questions in our remaining time.

MS. JACOBS: I have one question.

MR. FAGEL: Sure.

MS. JACOBS: I'm sure I'll get some of the specifics wrong, because it's not the criminal activity thing, but like when there's a question and we get comment, what are they called, comment letters or something about our filings or perhaps there was some kind of activity with trading and you get a FINRA letter that says, what do you know, and what was everybody doing on March 6th? That kind of a letter.

How come you answer everything, and then you don't get a response back? And you're supposed to believe that if the file is sort of divisible by two, it's over. Do you know what I mean? Or we don't get a response back from the Exchange that says, oh, we're okay with what y'all did on March 6th, and it's over. In other words, you never seem to get case-closed letters.

MR. FAGEL: Yeah. No, I understand what you're saying. There's a few different issues wrapped up there.

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In terms of FINRA, you know, when there is an insider trading issue, the exchanges are incredibly sophisticated. So they've got bells and whistles that go off anytime there's an announcement and significant trading in the days leading up to that. So it would not be unusual to get a letter from the exchange.

MR. JACOBS: Right.

MR. FAGEL: You know, NASDAQ will send a letter saying, can you tell us who was involved in this announcement? You know, I can't tell you what their practice is and why they do or don't respond to what happens afterwards to the extent that results in a referral from the exchange to us, which is typically what will happen.

If we begin investigating and talk to you, it is the practice, standard practice of the Division of Enforcement that we complete -- when we complete our investigation, we send a closing letter. That should be done as a matter of course.

It is the instruction to my staff that when we are done, you send a closing letter and say, we're done, and we're not making any recommendation to the Commission that enforcement be brought.

MS. JACOBS: Is that unique to y'all out here?

MR. FAGEL: No. That is the policy of the

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Division of Enforcement.

There are exceptions. If there is, for example, criminal interest or if there are different matters that are related and we're concerned if we send this closing letter to you and you make it public and it creates perception, that everything has gone away.

So there's exceptions, but for the most part that is the practice.

I do get this question periodically from defense counsel who say, well, we haven't heard from you. You can call. And, you know, I can't tell you how many times I hear, well, I'm afraid if I call, I'll remind you to take a look at this investigation.

My job is to manage what happens in my office.

We have multiple levels of management. I get -- have quarterly calls with Rob Khuzami, the Director of Enforcement in Washington, to go over our docket.

We haven't forgotten about the investigation. You're not going to remind us, oh, yeah, that case, we need to sue this company.

So it's not that hard to pick up and say -- and a lot of people do it, and say, you know, we haven't heard from you in some time, what's going on? Sometimes they'll say, you know, that slipped through the cracks, we're done. Sometimes we'll say, it's still going on.

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Sometimes, look, you get a difficult matter and it can take months and months for us to decide how to resolve it, to work through the Divisions in D.C. We can't bring any Enforcement action without the five Commissioners in Washington signing off. That process can take some time, especially for something that's novel or controversial.

So sometimes the answer is, I can't tell you what's going on, but I'll get back to you. But if it's really we're done, we'll tell you. That is the policy.

In terms of a letter to Corporation Finance, I can't -- I do not know what the process is for closing those down.

MR. NALLENGARA: We do the same thing. Our policy is to send a letter saying that we're done. And if we don't, you should -- you should call Marc too. I'm just kidding.

MS. GREENE: On a standard comment letter like something on a question on filing, isn't there -- and we haven't gotten one in a really long time, no big deal, but I think it says, unless -- once you respond, unless you hear from us, you assume --

MR. NALLENGARA: I think --

MS. GREENE: Is that old?

MR. NALLENGARA: Yeah, I think that's old.

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You shouldn't be getting that.

MS. GREENE: I don't know how long it's been.

MS. ZEPRALKA: We send a “no further comments” letter.

MR. FAGEL: Any other questions I can answer?

MR. DENNIS: What's your opinion of the crowd funding?

MR. FAGEL: What's my opinion of the crowd funding? Well, I leave it to the regulatory folks to make those decisions. I only have to clean up the mess when something goes awry.

Okay. I can't weigh in on that itself. What I can tell you is the Enforcement staff here gets very busy anytime it is easier for smaller entities and individuals to raise money. And that's the way it works. The more -- I do see that the regulatory burdens, as expensive and onerous as they may sometimes be, they minimize fraud. So it's a trade-off that the industry has to make and that the regulators have to make at what -- you know, what's the cost versus what's the fraud prevention?

You know, any time that there is more ability to, you know, widen the net of how many people can be out there raising money for more people, I'm going to get busy with fraud cases. And I can't tell you how many operators are already out there using the word

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"crowdfunding" in their offerings of what are probably outright frauds or Ponzi schemes.

So, you know, I think that there's some risk in there. You know, does it help small businesses? You know, that's not for me to say in the equation that I get into, but there are trade-offs involved. And I think it is important to recognize the trade-offs that it is going to likely result in some problems.

MR. NALLENGARA: Thank you, Marc.

MR. FAGEL: Thank you.

MR. GRAHAM: So that gives us five minutes.

MR. NALLENGARA: Give people time to check back home. Meet in ten -- no, no, five.

MR. GRAHAM: It's a negotiation. Okay. Ten minutes.

(A brief recess was taken.)

MR. GRAHAM: Let's get back together with the afternoon session. As you know, this afternoon we are talking about the disclosure rules of smaller companies and the issue of scaling. And we've put together a panel for this afternoon to give us some background.

And their full biographies are in the materials that you've received earlier. Let me just kind of run down briefly who you will be hearing from.

First is Steve Bochner sitting next to Lona.

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He's a partner at Wilson Sonsini with more than 30 years of experience practicing corporate and securities law.

From 2009 to 2012, Steve worked as the firm's chief executive officer, and is currently a member of its board of directors.

He also recently served on the IPO Task Force, whose recommendations served as the basis for the IPO-related provisions of the JOBS Act.

From 1996 to 2011, Steve served on the NASDAQ Listing and Hearing Review Council, and he also served on the California Department of Corporation and Securities Regulation Advisory Committee.

Steve also -- Steve was also a member of the SEC's previous Advisory Committee on Smaller Public Companies that was formed in 2005.

Steve, welcome.

Jeff Schwartz is an associate who -- we kind of skipped over you. I see "Bobby" in the notes. Do you go by Bobby?

MR. BARTLETT: I have never been able to shake it.

MR. GRAHAM: Well, we just skipped right over you, Bobby.

And finishing up with Jeff Schwartz, he is an Associate Professor at the University of Utah, S.J. --

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the S.J. Quinney College of Law. He teaches business organizations and corporate finance, and his research centers on securities law, investment-management regulation, and retirement policy.

Prior to joining the faculty of University of Utah, Jeff taught and practiced law in Southern California.

In practice, he served both as in-house counsel and as a corporate attorney for Munger Tolles where he represented clients regarding mergers and acquisitions, corporate governance matters, and securities law compliance. So Jeff.

Now back to Bobby. Robert Bartlett is a Professor of Law at Berkeley. His primary research -- his primary research interests focus on the intersection of finance and business law, and he teaches in the areas of securities regulation, corporate finance, and contracts.

He also serves as a member of the faculty for the Berkeley Center on Law, Business and the Economy.

So that's -- is that a journal?

MR. BARTLETT: No, it's a center at Berkeley.

MR. GRAHAM: Okay.

MR. BARTLETT: Actually, Steve's there as well.

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(Outside noise.)

MR. GRAHAM: What is that noise?

Okay. Let's see. And you're an editor of Berkeley's -- of Berkeley's VC Research Network.

Bobby previously worked as a corporate associate at Gunderson.

So that is our expert panel, and looking forward to hearing what you have to say about scaling, if we can hear you through the scatter.

Who are we starting with?

MR. BOCHNER: Starting with me. Great to be here. Sitting awfully tall. Unusual for me. So it's really a pleasure, a privilege to be here today. It's hard to believe that our -- I was on the SEC Advisory Committee seven years ago. And Leroy was on that committee, and there was another member who -- Richard Brown, who's in the audience today. It was a great experience. And many of our recommendations did translate into -- directly and indirectly into real (inaudible) form.

So we found that the staff took the recommendations very seriously, and we felt like we made an impact. So I encourage you to take advantage of this opportunity.

Some of the things that we focused on in those

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days was -- SOX was pretty fresh, and so we spent an inordinate amount of time on 404. And I think it had some role, Leroy, in actually getting the auditing standard changed. I think we can take some credit for that.

Other things like integrating S-B into Regulation S-K, which got rid of the stigma of using small reporting rules and other types of scaled disclosure.

So I think you can make a real impact.

And so some of the dialogue really hasn't changed a lot from those days. But 404 just sucked all of the oxygen out of the room. It seemed for most of those sessions, we did spend a fair amount of time on scaled disclosure. And obviously that continues to be an issue, how to make the markets, how to make securities regulation achieve that very delicate balance between investor protection and capital raising.

So we struggled in those days to try to find it. I'm sure you're struggling to try to find that balance as well.

I'd like to start my remarks with making a connection between the prior panel and the scaled disclosure. I do think market structure is directly related to the scaled disclosure issue. I'll talk a

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little bit more about that in a moment.

I think we're at a really important juncture here, and I feel that even more so than what we've learned since. And the reason I think we're at a unique juncture, we have a confluence of changes in technology, market pressures, foreign competition, all kind of coming together and I think creating a cocktail of, you know, whether you call it innovation or a thought process, that's really challenging what has up to now been a fairly rigid structure, you know, for 80 years since -- almost 80 years since the Securities Act of 1933 was adopted that sort of envisioned a two-tier world: a paper-based world of purely private placements, you know, with some exception. And then full-blown Sarbanes-Oxley, Dodd-Frank compliant world, a public world.

And I think what you're seeing now is that paradigm being challenged, being challenged for a number of reasons. But one of those is that I think the confluence of increased regulation, some of the trading issues we've heard about this morning, and we're going to hear about later on today. Investor expectations has created what I call a gap in the capital market. I think this gap is tangible. And you in fact have been talking about it today. It's a gap that's characterized

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by how long it takes to get a company public.

In my world, which is kind of Silicon Valley technology companies, you got a hundred million in revenue now and have market caps that are approaching a billion dollars. We really don't have a viable chance -- absent some hyper-growth story perhaps, we really don't have a viable chance of getting Goldman Sachs, J.P. Morgan to get interested enough to expose you as an IPO candidate to a client base and -- their customer base.

This -- this gap that's developed between the private finance world, the seed round, Series A, B, C, D, and then going public, which used to occur over five years and used to occur when companies noted a $30 million revenue range. If you go back and look at Cisco and Apple and Microsoft's prospectus, they really could not go public today because they just don't have the scale to support the expense structure that frankly investors would expect through a company.

And this gap -- some aspects of this gap I think are good things. You know, I think to the extent that we've improved investor protection with -- with listing standards and regulation/government reform, some of that is quite good for the retail investors I suppose.

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But what it's done in that gap, that move from five years to ten years, that move from 30 million in revenue to a hundred million in revenue, that increased expense structure to support a public company, is it's created capital raising and liquidity challenges in the end. And that's, I think, a lot of what we're talking about and saying.

As we talk about market structure and talk about scaling regulation, I think we're really zeroing in on that gap. And that gap is important because it turns then to foreign competitiveness, growth -- economic growth, job creation, and the like.

The '33 Act construct, as I mentioned a bit ago, is looking increasingly out of date. You can see -- you can see that out-of-date aspect to it, not only in the size of the companies that are going public today, but just in the use of technology.

The idea that -- that information outflows instantaneously, versus 1933 when you actually had -- the rules were designed for paper-based, or paper changed hands. Investors can get information instantly. The idea that the prospectus was the sole disclosure document created a regulatory environment around this sort of sacrosanct piece of paper that we use to audit or offer securities.

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Now that's coming under a lot of pressure as investors are bombarded with all sorts of information, and they can get it instantaneously.

Professor Schwartz, whose paper I read, I think shares these observations about the outmoded nature of our market structure. I think there's only going to be increased pressure on our market structures as the need for -- I don't think this gap is going to go away. We may be able to ameliorate it with some reduced disclosure and so on. But I think when the retail investors dispose, I think it's going to be very hard to submit and grow back a lot of reforms.

So what I'm intrigued about, is there -- is this two-tiered market structure the best that we can do? Is that construct from 1933 really the right construct, or are some of these new models that we're seeing fill this gap that I described, whether it's, you know, the SecondMarket/Sharespost providing liquidity or AngelList providing capital raising capabilities, should that be the solution as opposed to sort of arguing about when we roll back SOX, what's the level of disclosure and so on? Can we be more innovative with different types of market structures that I think are very much in the vein of scaled disclosure? Scale disclosure by sort of taking the public company world

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and trying to roll back disclosures based upon the size of the company.

But that always presents a dilemma because those are the -- the smaller companies are the riskiest companies. So if you roll back disclosures -- and this is some of the dialogue we had in our '05, '06 SEC Advisory Committee -- roll back disclosures for those who compromise investor protection, the risk is kind of cumbersome. So that's the dilemma.

Whereas a market structure sort of solution where you tier access to different markets based upon the type of investor so that you -- investors that don't need registration-level protection perhaps have access to different kinds of markets maybe with different tick sizes and some of the other innovations that all of you are talking about, I think that's what -- that's what intrigues me.

So I encourage you to think about scaled disclosure and recommendations in both contexts, both -- you know, are there things -- is there low-hanging fruit in terms of current securities regulatory environment disclosure requirements and audit standards that really are overkill and not necessary for investor protection, kind of relook at that balancing between capital-raising investor protection, but also take a look at whether the

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actual structure of our market, this two-tiered world, this two-tiered regulatory environment, I might call it with some license, because obviously there's SEC rules that do different things. Reg A might be a good example.

But by and large, that's kind of how -- you know, that's how the world has worked. Private placements, public offerings, those worlds have gotten further apart, it's created this gap in the middle, all this pressure. And I think that's a big reason why you're here today.

Some of the changes that we need to bring about these kinds of market structure innovations we recommended in 2006. And some of them have been addressed at the SEC Small Business Forum over the years or in the report. I remember that; I presided over that.

And some of them are -- have become law and are about to become law under the JOBS Act. And examples of that are Section 12(g) relief, the 500 shareholder relief, facilitating new methods of solicitation using modern technologies.

Knocking on doors on Sandhill Road is one way to find investors, but we have -- if we can find people spouses on the Internet, can't we hook up more

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efficiently investors and companies in some way that doesn't compromise investor protection?

Professor Schwartz points out in his paper additional solutions should be scaled. I mean, the size of the issuer, the investor protection. And that would -- I think that would not only help with capital formation and job creation, but also help our foreign competitiveness against markets, which still have yet, I think, to be a real threat to our domestic markets here.

But I don't think that's going to last for a decade or two decades. I think more markets are going to compete for listings or certain listings, companies in those areas. I think they've done that successfully.

Where they have been less successful is competing for listings with, you know, the mainstream U.S. venture backed high profile issuer. We've managed to hang on to those, but I don't think we can take that for granted.

You know, I think, as is the case with other industries, the U.S. should innovate their market structure, the same way it is innovative with respect to information technologies and life sciences.

So I've been pontificating a bit, but I do have some specific recommendations about things that you

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can do.

Before I go to those, let me -- let me just talk about an example of a new kind of market structure, which is AngelList. And if you haven't seen AngelList, it's an online marketplace where you have to get -- you have to prove you're an accredited investor, and companies can list matches, investors, and companies.

And we -- I think just a couple of days ago we announced in conjunction with AngelList that we are -- that they put up a new portion of their website where startups can go and basically close a financing on an automated basis using documents online. And we -- and we committed that for clients we then take on -- we'll do that part of the closing process for free.

So you can see the, you know, the amazing change over just a decade ago where you can go -- where you go on a website, hopefully get access to investors that are interested, have a term sheet negotiated, have financing documents created. And basically lawyers who author them still need to be involved in things like disclosure schedules and organization and securities law for clients. But the basic fundamentals of generating a term sheet and generating a document and finding investments are automated, and I think that's really cool.

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And I think there is -- excuse me. I think there's more of that to come. And I think SecondMarket and Sharespost will reflect that innovation with respect to liquidity.

Several years ago I gave a series of talks on what kinds of regulatory changes would be necessary to bring about innovation with respect to these alternative markets. And I said there were four changes which need to be made in order to have kind of this gap filled with a different kind of market structure.

I said one was a change to the 500 shareholder test. Because if you had a robust alternative market, as soon as you got the 500 shareholder, you go public, you know, nobody was going to do that. You weren't going to have meaningful liquidity. So I said there needed to be some relief to allow companies to be able to operate in that segment without fear of having to register.

I said secondly there needed to be some changes to the general solicitation provisions to use modern technologies and access a broader swath of investors using technology.

Thirdly, I suggested that federal preemption of Blue Sky laws was necessary because Blue Sky amounted to a 50-state Blue Sky compliance check. And to do

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compliance work, using a private company is expensive and burdensome.

And lastly, I said that you needed to provide better liquidity through 144 amendment.

So I said, if you could imagine all those things being done, you could envision a different kind of -- kind of market structure, perhaps with different governance standards and listing requirements that could provide some amount of liquidity, some amount of capital raising, and be accessible by investors, that, from a regulatory point of view, whether it's accredited investors or some higher standard, are investors that are deemed not to need registration’s protection. So sort of a scaled market approach.

So interestingly, the first two have actually been accomplished during the process being accomplished by the JOBS Act. You have 12(g) relief under the JOBS Act. And the SEC, as Lona indicated this morning, just published a proposal regarding the general solicitation provision. I'll comment on that in a moment.

I think that the two other changes are ones that I hope you think about.

One is -- one is 144 change. And let me explain it this way: Under Rule 506, if I'm an issuer, I can sell stock to an accredited investor without

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registration. And let's say that investor is Sequoia Capital, a well-known venture capital fund. Sequoia Capital, though, if it wants to sell those shares and rely on an SEC safe harbor, it has to have a one-year holding period, even if it's selling those shares to Kleiner Perkins. And the reason that that's an issue is that creates stiction. If you imagine an efficient middle market -- actually, it's stiction, which I believe is unnecessary.

In other words, if an issuer can tell -- sell to Sequoia without registration because Sequoia meets whatever standards are put into place for investors who don't need registration-level protection, why does Sequoia have to endure a one-year holding period to sell to another similarly situated investor? I would argue you don't need that. There's no investor protection mandate in that one-year holding period as long as the transferee meets the same standards as are required when that first investor parts with their money.

So I think what that would do -- there is a "if we build it will they come" aspect to this. That may be above my pay grade because it really relates to our institutional investors in the market, you know. But early indications if you look at AngelList are -- I think are certainly intriguing in that regard.

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MR. WALSH: Do you know the rationale for that decision years ago?

MR. BOCHNER: What's that?

MR. WALSH: The one-year hold.

MR. BOCHNER: Yeah, there's a good rationale for it. And Lona can chime in here, too.

But the thinking is that if you have -- if you go through -- from a regulatory point of view, if you require a company to file a registration statement, you know, that exposes retail investors. If you have a private placement, you don't have to do that with certain standards that you put in place like accredited investors.

But yet, if accredited -- if you are an issuer, I can sell to an accredited investor, and the accredited investor can turn around and distribute the shares publicly to a bunch of non-accredited investors without registration, then that’s just really an end-run around the registration requirement.

So it was put in place for a good reason. It's just that I think, you know, this -- you know, the idea of this sort of secondary market, this middle market was not really in existence then.

So I think we now need to expand that thinking to say, well, trans -- we don't need a one-year holding

period if the transferee meets whatever standards we set for not needing registration level protection. So --

MS. SMITH: Steve, your standard of time that they're warranting, you know, that there's a demand for accredited investors wanting to pick up that (inaudible).

MR. BOCHNER: Karen, well, you're -- given your background, you probably have more expertise on this than I do, but I think you suffered from the other side of that in your prior role because I think there's -- the answer is, from my experience, that companies do want that, but they want to control it. And so I think a lot of, what I know you had to deal with in your prior life was sort of the bad side of that, shares getting out, being out of control, worrying about the 500 shareholder test, worrying about the company liability.

So I think that the standards aren't in place yet, but I think the issuers would like to facilitate that liquidity, but control it.

MS. SMITH: Because the issue we had (inaudible) --

MR. LAPORTE: Could you make sure to speak into the microphone, please?

MS. SMITH: Sorry.

I mean, I think we have the issue of the example of Sequoia wanting to sell to Kleiner, it was employee A wanting to sell shares to some random person to offset the market. I guess I'm just curious (inaudible).

MR. NALLENGARA: Yeah. It's a fair question whether Sequoia can sell it through some trading facility, not sell it through another private -- I mean, their -- your question is whether they -- whether they can freely trade the securities rather than rely on other private placements to sell the securities. So, you know, Kleiner -- Sequoia sells to Kleiner, the problem is you couldn't sell it, you couldn't put it in newspaper ads and sell the securities you bought.

MR. BOCHNER: Oh, correct, yeah.

MR. NALLENGARA: What you're suggesting is someone taking advantage of some -- someone being able to take advantage of AngelList or some list like that to be able to sell the securities.

MR. BOCHNER: So if AngelList -- if AngelList, not to pick on them. You imagine some market structure that's a credible market structure, maybe it has listing -- some listing standards, maybe some governance standards, but well below the Sarbanes-Oxley, Dodd-Frank level. It would be a place where you could go to raise

capital, like AngelList is facilitating today. And hopefully there is going to become a meaningful middle market, would allow some -- some liquidity.

And if I were saying that there would be an issuer control liquidity, I think the issuer should have control have to (inaudible) to the board.

But to the extent that you had a one-year holding period existing today, so you actually had to buy it, that would create a lot of inefficiency. But there's -- you know, there are other ways to trade securities like the four one and a half exemption, but there's sort of a race to the bottom.

You're smiling, because you're well aware of that.

So we do need -- I think we do need either -- in order to -- if you like the idea of a different market structure and you like the idea of having some liquidity in that market structure, then a one-year holding period doesn't make sense. As long as the buyer of that is also on that -- on that marketplace that only allows investors that don't need registration protection and is done in a way that the issuer has decided to take advantage of. So the issuer is always going to say, I'm either going to list there, I'm not going to list there. I'll allow my shares to be traded there.

And certainly, as you point out, Karen, I think a lot of the liquidity strains are coming from employees who have worked for seven years and they want to buy a house or they have other health needs or whatever, and yet the company can't go public yet. It doesn't meet this ever increasing threshold to go public. I think a lot of stress and strain, frankly, I think a lot of these business models are propped up to deal with that.

And I think your prior employer is just sort of one of the very early companies that started -- that had gotten into -- that was kind of dealing with an environment that was equipping it with all sorts of issues. And some of these, like the shareholder test, help ameliorate to some degree.

So I'll hurry up so I'm not taking too much time away from these other presentations.

So the first of my recommendations are to consider both whether the 144 one-year holding period makes sense if the transferee meets certain standards. And the second is federal preemption with respect to that secondary transfer, some kind of a 50-state Blue Sky.

Secondly, and this is a little long-term, I think the 500 shareholder relief is welcome. There's

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one little tweak that I'm kind of unhappy with, which is that while employees are excluded from the -- now the 2,000 shareholder count, accredited investors aren't. And I would argue that if an accredited investor can buy shares from an issuer without registration, why should just a sheer number of them give rise to the need for registration under the '34 Act?

So I think in addition to employees being excluded from the account -- 2,000 shareholder count, which they are now under the JOBS Act, in theory, that the protections aren't needed because these are compensatory transactions, not capital raising transactions. I think the same theory should apply to investors that are determined under other SEC rules not to meet registration-level protection. So just adding -- adding the numbers shouldn't give rise to that.

So my second recommendation, and I think this is longer term, but would be to exclude accredited investors from the count.

You know, I have a third recommendation, which is not really in the scaled disclosure area, but it relates to Rule 506. Lona heard me make it on a webcast the other day. But I think the SEC's proposed rule under the general solicitation provisions is too broad.

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I was -- as Steve mentioned, I was a member of the IPO Task Force that helped come up with some of the ideas behind the JOBS Act, and general solicitation was one of them.

But I certainly don't want to see late night TV ads, newspaper ads, Internet, you know, commercials, you know, blasting, hawking stock. I think that's bad for the markets. I think it's bad from a regulatory point of view. And I think it's bad for the kind of reforms we're talking about here.

And it -- you know, the question is whether the SEC has the authority under the JOBS Act to constrain that. I actually think they do. I think it's -- I think even though the bill says eliminate the general solicitation provisions, I don't think that means that the SEC can't regulate as to how that solicitation occurs. And I think the SEC's experts in these areas will have to decide whether or not I'm right about that.

But I think SEC rules like 134 and 135 provide a really good template for when the retail investor is exposed, you know, how a company should be permitted to offer stock in newspapers and TV and ads. That's my third recommendation.,

My fourth does finally -- I should get to scaled

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disclosure. We took a hard look at this. We -- in '05 and '06 -- we suggested that many of the small business reforms get made accessible to a broad swath of smaller public companies. And these are things like a reduced business section, reduced MD&A, reduced market risk disclosure, reduced executive compensation provisions. Some of these are addressed in the JOBS Act.

I would encourage you to look at the threshold, to read it, that was established as a result of our work in those days, which is a smaller reporting company, $75 million in market cap, which is not very meaningful. You get a company public with that kind of market cap and ask yourselves whether that threshold ought to be raised with some meaningful number.

You know, back in '06 we were -- I haven't updated this, but I think we were given the information by the SEC Office of Economic Analysis, which said that companies above $787 million in market capitalization represented basically 94 percent of U.S. market capitalization, meaning that companies below that market cap are very unlikely to result in systemic risk. You know, you're just not having that much of a market cap affected.

And you kind of use that as a theory to say, well, if that's the case, there's no real systemic risk,

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which is sort of -- those were in those days Sarbanes-Oxley and Dodd-Frank, let's see if we can't do some things to make the disclosure burdens lessen. So take a look at the scaled disclosure, the size, and see if there's other low-hanging fruit out there.

And then I have one more recommendation. And I have a prop for this recommendation, actually, that Lona took a peek at.

This is my prop. And this is -- this is -- I had printed out a client's filings.

Anybody guess how many years of SEC filings this is for my client?

PARTICIPANT: One.

MR. BOCHNER: One year. And this is a --

there's a proxy statement, 10-Qs, and one 10-K. And back in '05, '06 we actually recommended that EDGAR be reformed and looked at.

EDGAR, you know, is a -- if you go on EDGAR today, what you get is sort of a chronological listing of filings. So 10-Q, 10-K, bunch of forms, proxy, 8-K.

And it's very hard to find stuff. You know, where's the current business section, where is -- I mean, I couldn't -- if you ask me, and I kind of read this stuff for a living, tell me what the CEO made last year, I can sort of find it, but it would take me a

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while. I have to know what document to go in.

And there's a lot of repetition in here. There are financial statement footnotes that repeat over and over and over. And it takes a lot of work, lawyers reviewing it, accountants reviewing it.

And I would argue that, even if this is written in plain English, this really isn't plain English. When something gets this big, it's not plain English. It's just hard to find.

So I think that -- there was an SEC initiative many years ago called the 21st Century Disclosure Initiative. I think it generated some ridicule to call it that. But I actually think it proposed a really interesting idea, which is to sort of do away with the idea of the serial chronological list of filings.

And when a company goes public, they file a company registration. That's their document. That's a disclosure document. And every time a quarter occurs or year occurs, you update that document, and you can see where it got updated. So there's one static document. As the business section, as the current comp, you can go back and I think with technology figure out what the company -- what changes had gotten made. But basically there's one place to look.

And I think it would make -- I think it would

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reduce costs, and I think it would make the ability of investors to ferret out information much, much better and can actually help the rest of us.

So, again, thanks for having me here today, and I really look forward to reading your recommendations.

MR. GRAHAM: Thank you, Steve.

Who's next? Let's go. We think it's you, Jeff.

MR. SCHWARTZ: Okay. So, first of all, thank you very much for inviting me to share my thoughts today. I think, Bob -- Mr. Bochner --

(Outside noise.)

I think I'll wait.

(Pause.)

Okay. So thanks a lot for having me. I'm very excited to share my thoughts with you all. I've been following the committee closely from afar. I watched the webcast of the last meeting, so it's a little surreal. I actually recognize all of you, but you don't recognize me. And that's all a little surreal.

Anyway, so in preparing my comments for today, what I tried to do is to make them as relevant as possible for the Committee at this point in time as you

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all seek to improve market conditions for small and emerging companies.

To that end, what I thought I would do was first briefly assess the helpfulness of scaled disclosure and other current efforts to provide regulatory relief to small and emerging companies. I plan to focus on the smaller reporting company or SRC rules that were adopted a few years ago, and then talk a little bit about the JOBS Act, which, of course, was adopted earlier this year.

Second, I'll offer my thoughts on what might be advisable next steps to build upon those recent reform efforts. I'll offer suggestions about how to identify candidates for reform, and I'll give a few suggestions of my own.

And then finally, I'll discuss if -- rather than having small and emerging companies trade alongside large established ones in the same market as we do today, it might be better for these firms to have their own market, with each of these markets set up with specifically designed regulatory frameworks. I think that builds a lot on what Mr. Bochner was saying earlier.

So, first, turning to the Smaller Reporting Company rules, the SRC rules essentially provide for

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scaled disclosure for companies with a public float of under $75 million. As was already brought up, what this allows for, is it allows these companies to provide fewer years of financial statements and less information about their businesses and about their finances.

And while this seems like a nice change, what's important to note about the SRC rules is that, in substance, they're based upon around and largely a continuation of the Small Business Issuer rules, which has -- which had existed since 1992 throughout the period of IPO decline.

What happened was that when the SRC rules were put in place, the SEC essentially merged Regulation S-B into Regulation S-K. And while this certainly cleaned up the statute a lot, the adoption of these new rules didn't do anything to offer any additional regulatory relief to these small and emerging companies.

What the new rules did do, however, was

broaden access to scaled disclosure. Under Regulation S-B, in order to qualify as a small business and to receive scaled disclosures, you had to have under $25 million in revenues and a public float of under $25 million. Whereas, as I already alluded to, in order to qualify for special treatment as an SRC, you can have up to three times that amount in public float.

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So the rules did make a substantive change here, in that, while they didn't actually provide for more regulatory relief, at least they brought in the number of firms that would be able to take advantage of it.

But, as was already pointed out, $75 million is a very small number. So it only extends the regulatory relief to the smallest of the public companies.

And while it's difficult to make too much of this, the adoption of the SRC rules didn't seem to move the needle much in terms of IPOs. In other words, the IPOs continued to decline after the SRC rules were put in place, which at least suggests that it didn't do much to make the public market that much more attractive to emerging companies.

So my bottom line for the SRC rules is that, while their heart is in the right place with scaled disclosure, the regulatory relief that the rules provide was likely too modest to do much good for any companies that we're concerned about.

The JOBS Act, though, can be seen as an attempt to offer further assistance. And in contrast to the SRC rules, the JOBS Act did make a lot of changes. But I'm not that optimistic that the JOBS Act will do

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that much to improve matters either.

So one thing that the JOBS Act does is that it focuses on emerging firms to the exclusion of small ones. So small companies that went public prior to the JOBS Act got no additional regulatory relief under the statute. And similarly, those companies that do go public under the JOBS Act lose the protection of the statute after five years.

Another concern I have is that, even what the JOBS Act does attract -- so what the JOBS Act does do is it provides regulatory relief for emerging firms, I'm afraid that the regulatory relief it provides for emerging firms doesn't do enough to make the public markets more attractive for them either.

What the JOBS Act does, among other things, is that it eases the rules on providing research reports regarding emerging companies, both before, during, and after the IPO process, and it also adopts some scaled disclosure. But the scaled disclosure that the JOBS Act provides for is rather modest.

And with respect to the provision of research reports, there's been some rumblings that investment banks and analysts are taking a wait-and-see approach before taking advantage of the regulatory flexibility that the statute provides for. So I'm not confident

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that those JOBS Act reforms will lead to that many more public companies.

And finally, one particular worry I have about the JOBS Act is how the on-ramp provisions of the Act, which are designed to make going public more attractive, interact with the changes to Section 12(g), which, by raising the shareholder thresholds which trigger public reporting, makes it easier for companies to remain private.

What I'm concerned about is that because of the changes to Section 12(g), more companies are going to opt to remain private, and that this undermines the goal of the on-ramp provisions and also can contribute to the further erosion of our public equity market.

While this might be defensible, while having firms stay private might be a defensible outcome, it might be a defensible outcome if we thought that the private markets had something to offer these small and emerging companies. If we thought the private markets offered a viable alternative to small and emerging firms, we might not be bothered by the fact that more companies are opting to stay private.

But my own view is that the private markets don't offer a viable alternative and that the lack of regulatory structure that supports liquidity and

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investor protection, and I think they raise various concerns to the extent that participation is limited to QIBS and accredited investors to the exclusion of everyone else.

The way I view the equity markets overall is that there is a -- is that there is in fact -- no, let me say it again.

The way I view the equity markets overall is that even though we have scaling in the SRC rules and through the JOBS Act, that even though we have this, there is this vast gulf between the highly regulated public stock markets and the lightly regulated private markets, and that neither of these alternatives is attractive to emerging companies. So it very much builds on what Mr. Bochner was saying.

And I think in light of this vast gulf, perhaps what is missing is an intermediate regulatory framework. And the way I picture this framework is as having many of the hallmarks of the public securities regulation, but at the same time containing significant-enough cuts to regulation to have a material impact on the amount that the firms we're concerned about actually spend on compliance.

Now, I'm under no illusion that regulatory change would be a silver bullet. As the Committee has

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discussed, there are a number of reasons that explain the decline in a small company market over time. But I don't think that's a reason not to make regulatory changes. I think that if we put our efforts into designing an efficient regulatory structure, it would help matters.

One way to go about this, one way to create this improved intermediate regulatory structure would be to broaden and deepen the scaling of regulations that already exist under the current rules.

So first, looking at the broadening as already noted, the SRC rules, special treatment under the SRC rules is limited to companies under $75 million in public equity outstanding. But there are far more companies out there that could likely benefit from regulatory relief.

In fact, maybe we should be looking at this from a different perspective. Maybe instead of only providing regulatory relief to the smallest public companies, perhaps everyone should get regulatory relief. Everyone, that is, except for the largest public firms.

Several academics have pointed out that the regulations that have been added on in recent years have had the largest public companies in mind. They've been

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targeted at their misdeeds. And there's really been an effort to hold these firms accountable for their actions. And that, really, small and emerging companies have just been caught up in the net.

If we look at the world this way, you can picture a structure, a regulatory structure where the largest public companies, the corporate high -- the S&P 500 type firms that make up the large percentage of the market capitalization, that these companies are subject to the highest regulatory scrutiny, but that small, midsized, and emerging firms are subject to an intermediate level of security.

So only the highest, only the largest firms would have this highest level of scrutiny. Everyone else would be subject to a subset under those requirements.

Okay. But what should those -- what should that subset be? So it's easy to say we should have an intermediate regulatory structure, but, of course, it's very difficult to actually come up with one.

In theory, regulation should decrease a firm's cost of capital, right, as investors feel less of a need to discount a firm's shares to account for fraud and incomplete information. This means that in cutting regulation, we raise the risk of actually raising a

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firm's cost of capital. And if we raise a firm's cost of capital by more than we lower its compliance cost, then we've actually done damage to the very firms that we're trying to help.

If we look at the world this way, then what it turns out we have to do is that we have to focus our efforts on finding those regulations that cost the most in terms of compliance, yet deliver the least in terms of benefits, deliver the least in terms of investor protection.

While this also is hard to do in practice, here's a list of some candidates at least to think about, some candidates for further discussion, for further investigation.

So up here, as you look at the regulation category, we have the usual suspects, I guess, of Sarbanes-Oxley and Dodd-Frank. Smaller reporting companies already get relief from Section 404(b) of Sarbanes-Oxley, but perhaps they could also get relief from 404(a), if not more.

Under Dodd-Frank, smaller reporting companies have a temporary exemption from the Say-on-Pay rules, but perhaps they could be exempt from a lot more of that Act as well.

The Committee can also look at the MD&A, the

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Executive Compensation section of the Exchange Act reports of these companies. There's already some scaled disclosure for smaller reporting companies when it comes to those areas, but perhaps these could be extended upon as well.

But I don't think the committee needs to stop and just look at how to scale regulation. I think there are other areas where reforms could help lower costs as well.

So if we look at the middle category, we have the litigation environment. Perhaps steps can be taken to make the litigation environment a bit less costly as well.

One area that the committee could look at is Rule 10(b)(5), at least as it pertains to secondary market transactions. So let me flesh that out a little bit.

So Rule 10b-5 is a foundational provision, but legal academics have actually long questioned the usefulness of 10b-5 damage awards against companies for fraud in connection with secondary market transactions in which the company played no role.

In these secondary market transactions, in this context, where the issuer was not involved with the

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transaction, these damage awards tend to lack a term function because the officers and directors who were involved with the fraud are rarely personally liable because they will be indemnified or insured. And these awards also lack a compensation value as well because what ends up happening is that these damage awards are both paid by and paid to diversified shareholders. So in the aggregate, what ends up happening is shareholders end up paying themselves, minus a sizeable chunk for attorneys.

So in light of this -- in light of the circularity of 10b-5 damage awards in this context, some academics have recommended a cap on 10b-5 damage awards. Perhaps if we can -- if all companies are in this cap, it can be something that can be applied to small and emerging firms.

I also have up there Section 11 liability. Section 11 is a provision of the securities laws that allows shareholders to sue based on material misstatements in registration statements. But the shareholders do not need to show causation or (inaudible).

This heightened standard -- or I should say this lowered standard in order to recover, this does serve an investor protection function; that is, it provides more protection for investors when they can sue without

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having as many elements to show.

But there are some folks out there who also think that the risk of Section 11 -- the risk of Section 11 liability is deterring companies from going public and also leading to overly costly and perhaps duplicative due diligence efforts in order for companies who are -- the companies are taking in order to -- in order to avoid being sued.

So in light of the expenses that arise with Section 11, perhaps Congress could amend the section, so that rather than providing that shareholders can sue based upon it, perhaps it can only be the SEC.

Finally, the other category I have up there is listing standards. Today, among other things, New York Stock Exchange, NASDAQ rules require that all the companies have a majority independent board. And while this also may serve an investor protection function, it's actually empirically and theoretically contested exactly how much investor protection good independent directors do. And it turns out that independent directors are particularly costly for small and emerging companies.

So perhaps some thought can be given to using these rules for small and emerging firms and simply having these companies report on the extent to which

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their directors are independent. And this is already required that they report on this, and perhaps that rule would just be in case, and be the sole rule, that relates to director independence.

MR. WALSH: Can I ask a question? What do you mean the more expensive independent director?

MR. SCHWARTZ: So there's a study -- so independent directors are just expensive because you have to pay them, right? And it just -- it eats up a greater percentage of the revenue of smaller firms to pay these independent directors.

So there's been interesting studies out there that show how much per dollar of revenue smaller companies are paying on independent directors after Sarbanes-Oxley, after these listing standards were put in place, and it's a very high percentage, much higher than it is for larger companies.

Does that answer your question?

MR. WALSH: Mm-hmm.

MR. SCHWARTZ: Great.

Okay. So those are my candidates for reform. I offer these as food for thought. But I also think it would be greatly helpful for the Committee, as part of its ongoing efforts, to dive deeper into the costs and benefits of securities regulation as it pertains to the

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companies that we're concerned about.

To add rigor to the difficult exercise of recommending exact reforms to the SEC and Congress, I think it would be helpful to do a couple of additional things.

So one of which would be for the Committee to either review or commission a review of the recent empirical scholarship as it pertains to the cost and benefits of securities regulation in this area. And beyond that, the Committee could even undertake or commission someone else to undertake its own study, a study where it directly looks at the cost and benefits of regulation in this area.

On the cost side, there can be a survey of listed firms, preferably firms that are emerging companies or smaller ones, to get a sense of what they view as the most expensive and intrusive provisions. But the cost is only one side of the equation, and likely the easier side to measure.

It would also be beneficial for the Committee to survey those who had input on the benefit side of the securities laws. So to that end, there could be a survey of sophisticated investors. Ask sophisticated investors what they look at when valuing securities. If they don't think something is important when valuing

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securities, likely it doesn't have that big of an investor protection benefit. Because if it has an investor protection benefit, that should be reflected in the price. And these are the people who drive the prices.

So like I said, I think what I mentioned are good areas to start looking, but I think digging deeper into the cost and benefits through your own study or by reviewing the empirical scholarship that already exists would also prove helpful.

Okay. Finally, to transition just a little bit abruptly into my final point, today, as we see on the right side of the slide, we have emerging growth companies and smaller reporting companies trading alongside larger firms in the broader public market.

Because of this, the special regulatory treatment to which SRC and emerging growth companies are entitled under the JOBS Act and under the SRC rules, because these firms trade alongside larger companies in the broader market, this special regulatory treatment is embedded within and, to the untrained eye, hidden within the broader public markets.

If we simply continued to broaden and deepen the regulatory relief provided under the JOBS Act and the SRC rules, what we would also do is continue with this construct, this construct where you have firms of

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various shapes and sizes all trading together, but all subject to their own specific regulations.

But I'm not sure this is the best approach. Instead, maybe it's better to separate things out, to have firms -- to have different types of firms trade on different markets, and to have these markets set up so that they have regulations and a market structure that actually fits these firms. And that's what we see on the left side of the slide.

In my article that was included in the background materials, I argue that we should have separate markets for firms at different stages of their lifecycle. So we would have a market for emerging companies and a market for midsize and smaller companies. And these markets could be subject to an intermediate regulatory structure.

We would also have a market for large companies. And this market for large companies would be subject to the highest level of regulatory scrutiny.

And I offer this suggestion because I think there are several benefits to separating different firms out into different markets that are narrowly tailored to fit those firms.

One advantage is that if we were to separate things out in this way, we would have regulatory

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consistency within each market. All of the firms in the market would be regulated similarly. This would mean that they would be easily comparable, which would increase efficiency on the market. Also, if we separated things out in this way, there would be less of a potential for investor confusion.

So, for example, let's say that Congress or the SEC did choose to put a cap on its 10b-5 damage awards for smaller companies. If this happened and if these companies continued to trade alongside larger ones in the broader public market, retail investors might not realize that these smaller companies have this limitation on litigation recovery. If, however, we had smaller and emerging firms trade on their own markets, we could make this limitation much clearer.

Another benefit of separating firms out into different markets is that you could structure the market itself to fit the firms that trade their own. So as this Committee has discussed at length, smaller companies face concerns regarding liquidity, and the SEC or Congress may want to tackle those concerns by allowing firms to choose their tick size or allowing them to pay for liquidity or through some other avenue.

If regulators want to take that approach, I think it would be much cleaner and much easier to do, if

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these firms actually traded on their own markets.

If instead you apply these tick size rules or other liquidity rules to these firms in this broader public market, I think it might be confusing, and it might just be difficult to do, and clearer if they were all separated out.

Like, it would -- for example, it would be much easier if the midsize and smaller company market had one tick size, and the large company market had another. Or a small company market, you had a regime where you could pick your tick size, whereas the large company market you did not, something along those lines.

Finally, the last benefit is that today when firms go public, they do so amidst a great deal of regulatory uncertainty. A firm goes public under one regulatory regime, but in a few years, there's a good chance that the regulations that they will be subject to will be much more demanding and expensive. And this has to cause entrepreneurs to think twice about going public at all, and must be doubly frustrating for emerging and small companies who tend to get swept up in these regulations that were meant to combat the misdeeds of others.

I think if we separated these firms out into different markets, it would be much more -- it would be

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much less likely that smaller and emerging companies would be swept up in these reforms that were meant for other types of companies. It would be much easier for regulators to target reforms at the appropriate firms and at the appropriate markets if different types of firms were separated out into markets meant for them.

And I think if regulations in the future were more well targeted at the appropriate group, it would be -- it would be both fair and more efficient.

So although I think moving to a model where you have different markets subject to different regulations is different than the current scaling approach that we've taken under the JOBS Act and the SRC rules, I think it does offer some benefits and is, therefore, a concept at least that's worth considering.

Thank you. I hope this helped.

MR. GRAHAM: I'm -- personally, I'm attracted to that concept. I think the whole notion of having at least two markets, or, you know, seeing some sort of system so that you can be more targeted with respect to the approach that you're taking with respect to each of those markets, based on who's participating.

Have you given much thought to the feasibility of actually implementing such a system?

MR. SCHWARTZ: A page worth in my article, out

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of 80. So I've thought about it. I have thought about it a little bit, and I don't think it would be terribly difficult.

So you already have the stock exchange. The exchange is somewhat set up to have different markets. So NASDAQ, for instance, has its BX Venture Market. You could envision setting -- so today the BX Venture Market has rules that are a little bit lesser than, but very similar to the rules that govern the New York Stock Exchange, more generally. You could picture that NASDAQ venture market being governed by a different regulatory template that is more intermediate in nature than it is today, where it's just a slight tick below the New York Stock Exchange.

So you could picture -- you could picture markets adjusting -- you could picture the SEC working with FINRA and the stock markets to actually change regulations to fit existing -- to fit at least what NASDAQ started to do.

So I don't think implementation would be easy, but I don't think it's impossible either. It's just a matter of changing listing standards and changing regulations and having FINRA and the SEC and Congress work together to do that.

(Talking simultaneously.)

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MR. GRAHAM: Go ahead.

MR. DENNIS: Oh, I was going to say, one, we've got a market study for this. And kind of with what Steven and I addressed on the previous Committee we had, the big issue you've got to deal with is perceptions because investors and companies are probably going to view the emerging company market in your example here as substandard compared to the large company market. And so you, you know, you have to get back by that psychological disadvantage. To me, the regulations part, that's the easy part.

MR. GRAHAM: I don't think you have to do that, though, because it says -- going back to the gap that Steve was describing, you got your private companies with a different set of rules, you got your public companies with a different set of rules. There's no particular stigma necessarily attached to being a private company versus a public company.

But you do have this gap that is drawn between those two segments. And if you just fill the gaps so you have a natural progression, now I'm thinking necessarily, you know, arrive at a situation where there is going to be stigma attached to being in -- kind of the first market that you hit to -- that you hit as your company is evolving.

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You know, simply put, you have private companies, then you have a market that is only for accredited investors. Then as companies grow, you got basically what we have now.

So it seems -- seems more like there's a way of doing it without kind of stigmatizing the participants the way, you know, Regulation S-B stigmatized companies.

MR. DENNIS: I think -- I think that's the biggest issue, is how do you -- I think like putting the regulations together and how you logistically transition is -- we can do that. I think the question is, will people want to automatic -- the Facebooks of the world are going to automatically want to jump to the highest one and --

MR. GRAHAM: That's good. They're -- you're up to, you know, the Facebook stage, they have plenty of resources in terms of compliance, etc. So, you know -- so imposing on companies of that magnitude the requirement that they go through the effort to provide the level of extra protection that -- with registration statement-type protection is not going to -- it's not going to be an issue for them because, again, they will have the resources. So --

MR. BOCHNER: I guess the -- kind of

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reconciling what Professor Schwartz talked about and what I talked about. I think the big difference, we kind of came at the same problem at a slightly different angle.

I think what I was envisioning was addressing that market, that -- those reduced requirements, and justifying that from an investor protection standpoint by limiting access to investors that are deemed not to need that greater protection.

And I think Professor Schwartz was sort of on that same theme, but saying, well, let's -- let's do that gradation by sort of size of company. And, you know, then the question is -- you know, they're both sort of the same ideas coming at it from a slightly different angle.

But the concern I had was whether -- I think yours is a bigger idea. I worry that it's more wood to chop in the sense that you're exposing the -- you know, you're exposing the non-accredited retail investor. I guess it's a question, really.

As you envision sort of that lowest end market, would you limit access to that market kind of the way I've envisioned in my -- in my world, or would you let any investor access all those markets, and they just sort of buyer beware based on the gradations of

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listing standards and compliance?

MR. SCHWARTZ: I've thought about that a lot, and I don't have any good evidence to support this view. But my bias tends to be in favor of letting everyone participate. I don't -- it bothers me to have markets that are restricted to -- that have special access privileges. I worry that retail investors aren't going to have access to the best companies if that happens. I maybe have this kind of bucolic attachment to public markets where everyone can participate.

So I am in favor of letting everyone participate and putting warning stickers on the market so that people can choose whether they want to be exposed to those risks.

And the other, I guess, more practical concern I have with limiting access to this intermediate type of regulatory structure would be I worry about liquidity and that whether there would be enough interest among accredited investors and institutional investors to support that market. And if we have retail investors, I think there is a better chance that we would have liquidity. So I think there's a trade-off between liquidity and investor protection, and I guess I kind of err on the side of liquidity.

MR. BORER: Isn't there sort of an analogous

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situation right now with the OTC market where they have this -- Cromwell Coulson runs this exchange. It used to be the Pinks; they changed the name because I guess it's a derogatory name -- where companies can list without being fully reporting, whether it's a foreign company that lists here without becoming SEC filers.

And they have, I think, three different tiers. One at the bottom, which is somebody can trade a stock with no reporting at all, there's no voluntary disclosure through OTC market, and there's skull and crossbones next to the name, all the way up to the ones who may trade there and be fully reporting, SEC compliant, etc. There's an intermediate level of disclosure, whether it is voluntary reporting to OTC markets, it's not a full SEC report.

And I don't know if anybody in the panel looked at that study and said, this is an effective market and it's a -- because I know with respect to a lot of what I've done over the last couple years, especially with foreign companies, they would come here and say, we want to dip our toe in the water, whether it's from German exchanges, Australian exchanges, a lot of Canadian companies in the resource sector, etc., that didn't want to go, say, fully to the SEC under MJDS and register in the United States; we're taking this as a

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step.

And it seems to me, at least with respect to the amount of trading that takes place there, that there's got to be enough trading to provide some level of good information to be able to decide whether it works.

MR. SCHWARTZ: You're right. That's a great point. The OTC market has tried to -- has tried to do this. And I haven't looked at it extensively, but from what I have looked at, they have not been that successful.

So what would come close is the highest level of the OTC market. I think it's OTCQX. That would be kind of the most similar to what I would be proposing.

I think the difference would be -- and it goes back to the point you raised on stigma. I think the OTC really has a stigma attached to it, and I think that prevents it from becoming this really true legitimate alternative because it has a stigma, so companies aren't -- aren't -- don't want to go there. I think OTC has this reputation as being the place where companies that are struggling can't meet the listing standards, are going bankrupt, it has a stigma of being that marketplace. So I think they haven't been able to overcome that stigma, and I think that's one trouble

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they're having.

Another difference is that the regulations at this OTCQX wouldn't be as high as I'm envisioning. At OTCQX, you don't have to file Exchange Act reports. You can do the OTC version of those reports. So it wouldn't be -- it wouldn't be quite as high as what I would -- what I had in mind.

And finally, unrelated to that, the difference that I see is that the OTC market doesn't have -- there's no SEC there telling them what their rules have to be. So they're purely self-policed. The OTC markets group polices the OTC because the securities laws don't put any parameters -- don't put any parameters on what their rules should be. Whereas from the market that I envision, there would actually be this securities law framework in place.

And I think that lends the market this

additional credibility, because when you just have a market that's self-policed, I don't think it's a credible market, and I think maybe that's also part of the reason why it's not. It's not a substitute for what I'm thinking about.

MR. GRAHAM: I want to just end things. Let's pause the discussion so that Professor Bartlett can have an opportunity to present.

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MR. BARTLETT: Sure. I can speak to some of these issues about the market.

So first, I just want to thank you for allowing me to share some of my thoughts on scaled disclosure with you.

I also want to thank each of you for being on this committee. I know you all have real jobs that require an extraordinary amount of time. So the fact that you decided to commit to this effort I think is incredibly meaningful. It's very important work.

When Gerry first asked me to be on this panel, it was something that I know is important because when I practiced, I remember drafting 10-Ks and 10-Qs. And now that I teach, I sort of sit back and I sort of observe more generally sort of the evolution of these forms, and it's clear there's this one-way ratchet that happens with disclosure. Most of the time we're adding more disclosure provisions, you know. So now we have executive compensation disclosures, now we've got sort of conflict mineral disclosures. It just keeps adding on. You see risk factors too, right. I suspect there's probably Y2K risk factors out there somewhere still.

So it's great we have an effort that tries to, you know, take a step back and rationalize whether or

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not we can actually have scaled disclosure that makes sense. Because I certainly believe that's the case. At the same time, I've also been daunted by the idea, and I also tip my hat to you for taking on this task because it's extraordinarily difficult to come up with optimal disclosure.

I'm very pleased that Jeff and Steve are both sort of more daring than I in actually coming up with proposals. And I think they make a lot of sense. In fact, I love this idea of sort of linking between SEC disclosure documents and I’m thinking we can actually plan to market something called a hyperlink. So I think that would actually be a great addition of the concept of EDGAR, basically come up with a way to use technology in a way that makes it easier, doesn't kill so many trees.

Okay. Well, what I'm going to talk about today, though, notwithstanding this statement that I actually want to see some unratcheting, some sort of ratchet backwards, I'm going to talk about the regulatory gap that I think you should fill. Okay. So, in fact, Steve got wind of this and intended to leave, but -- I'm just kidding, of course.

What I mean by this, well, what I want to talk about is a regulatory gap that I think should concern

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us, if we're concerned about small and emerging companies. Because the alternative of filling this gap from the federal perspective is to allow the states to do it, and we just don't want to have that. It's going to increase the cost of capital, it's going to increase complexity. I think it's something to be concerned about.

So what I would like to begin with is just sort of the conventional view of mandatory disclosure. Generally, we sort of view the need for mandatory disclosure as being driven by ownership structure. So you might have privately held companies, family-held, on one end of the spectrum, and at the other end of the spectrum you've got dispersed shareholders, many publicly dispersed shareholders, retail shareholders that trade in the marketplace.

Now, we say that this is basically going to map onto a disclosure regime, because if you're on the far side, if you're a private firm, there's every reason to believe you don't need mandatory disclosure because your investors won't invest without contractually getting rights to information. So this is a venture capital model, for instance, right. That we don't have mandatory disclosure there because we have sophisticated investors that have a relationship and influence and

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they can get the information that they need.

That's different, however, if you have retail, widely dispersed shareholders. You have large information asymmetries between the shareholders and the managers of those firms. There's also less of an incentive to provide the information if you're not in a capital-raising mode. And of course there's a collective action problem because the investors may not have, you know, the incentive necessary to demand the information in the same fashion that a venture capitalist would. So that's how we map our mandatory disclosures by looking to the ownership structure. And you see this in Section 12.

Section 12(a) basically says if you want to trade on a stock exchange, you've got to be subject to the Section 13 filing obligations, or if you have greater than a certain number of record shareholders. And sort of we'll table for the moment what that means for a record shareholder.

So you have a certain number of shareholders in ten million in assets, you also need to be subjected to mandatory disclosure because we use that as a proxy to say you're kind of in the public ownership space. Okay. So therefore we're going to subject you to mandatory disclosures.

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Now, to give you some examples, we have, you know, plenty of private firms that don't disclose, or at least privately owned. So Bechtel, for instance, family-owned firm. Twitter, we say, you know, it's generally a private company, for the most part, venture capital investors and employee shareholders. On the other end of the spectrum, you've got companies like Google, GM. Zoom, it's a small -- it's a smaller public company that trades on NASDAQ. And then we map that to disclosure, which also is in some sense, it's all spectrum, sort of, right?

So we have large accelerated filers that are subject to all the rules. Then we also have smaller reporting companies, which Jeff discussed, and Jennifer provided a wonderful summary of a few meetings back, I believe.

And so what we do is we then map these public companies into their appropriate bucket, based on whether they need the metric for smaller reporting company status or otherwise the residual categories of accelerated and non-accelerated filers.

These other firms, however, are not subjected to Section 13. Okay. So the question to ask is: Should we care about scaled federal disclosure in this? The answer is yes. The reason I say yes is because if we

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don't regulate this from a federal matter, I believe, my intuition and sort of my prediction is that we're going to see increasing movement on the state front. So I think that behooves us to think seriously about whether or not it makes sense from both the issuer perspective as well as an investor perspective to impose some form of scaled disclosure in this space.

And one of the reasons I think this is going to become more important, because that space has gotten much, much bigger in light of the JOBS Act, because of the fact now we went from 500 shareholders triggering the thresholds all the way up to 2,000 non-employee shareholders.

Okay. So that's basically why I think we should care about this.

Just give you a quick outline of what I'm going to talk about. I want to just go through in some fashion the legal rules about why it is that these private firms, these non-Exchange Act firms are in fact subject to disclosure obligations.

I realize it sort of seems like a paradox or just contradictory. So I'm going to explain why it's not. I'm going to explain why there's some problems with the state of affairs. And then lastly, I'm going to explain what the Commission can do about it with its

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existing rulemaking authority. Okay.

So first, why is it that existing non-Exchange Act companies are subject to disclosure obligations? Well, let's take that -- take our dichotomy again. Ownership on a scale, we also have a disclosure vector as well. Let's not make it mutually exclusive. So you have this two-by-two grid, right. You could have on the one hand a privately owned company that doesn't -- isn't subject to the federal regime.

So, for instance, Bechtel, okay, privately owned. It doesn't -- it does not disclose anything through the federal EDGAR system for instance.

On the other hand, you could have a public, public company. You have GM, lots of dispersed shareholders, and they also trade in the New York Stock Exchange; and so, therefore, they're subject to Section 13.

But it turns out that these other two boxes can also be filled. So to give you an example, Toys 'R Us, privately held, went through a leveraged buyout a few years ago. If you look them up on EDGAR, they're there. Why did they do that? Anyone have a guess?

MR. WALSH: Debt.

MR. BARTLETT: What's that?

MR. WALSH: The debt.

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MR. BARTLETT: The debt, right. Because, of course, the capital structure here is privately owned in terms of the ownership, but it has widely dispersed bondholders that was funded the LBO through high yield debt. And so, therefore, the bond investors, through the power of covenant, they say thou shalt file all Section 13 Act reports because that helps facilitate the trading market for high yield debt.

We also have this other category here. So these are companies that are privately held. I'm sorry. They're private in terms of their disclosure. They do not show up on EDGAR, in terms of their Section 13 report.

But if you look at their ownership structure, they're kind of public. In fact, on this spectrum of ownership, they have drifted far from the family-owned model, much toward the Google widely dispersed shareholder model. So Twitter, for instance, got that way because of SecondMarket and SharesPost, and the ability to basically trade off the grid through private resale transactions.

And likewise, Proxim Wireless trades on the over-the-counter market it was formerly the Pink Sheets, and rebranded itself on the OTC market. And I'd like you to just take a look at Proxim, for instance, and why

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it is the case that I'm making a claim that this is a public company that raises all the same problems that we have with information asymmetry and the inability to contractually get information that investors might want.

So if you go to OTC Market. Okay. Here we go. And we added the Proxim symbol. So far this kinda looks and feels like NASDAQ. You get Proxim Wireless Corporation. You see the inside quote. You see the price, $1.55. You see the volume. Doesn't trade a lot, but it does trade. You also get a lot of other metrics. For instance, there is some financial information, but it hasn't been -- they haven't filed any information since 2010. Okay. This is a formerly public company, public Exchange Act that went dark. They now trade OTC.

And they do in fact trade. So here, for instance, historical trades of Proxim. You see it's not a lot of volume, but in any given day you could have a few thousand shares change hands. And these, of course, are changing hands among dispersed shareholders. This company, from an ownership perspective, is actually quite far along the spectrum from private to public.

So my contention is that it's a publicly traded firm and so it raises the same policy considerations that have long justified mandatory disclosure.

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Now, why isn't it subject to federal mandatory disclosure? Well, that's just a function of the way that the federal securities laws work. If you're a securities lawyer, this will make a lot of sense to you; if you're not, just trust me.

So basically -- so the way it works -- so if you want to avoid Section 13 obligations, then you make sure that you don't trade on the stock exchange, and that you have fewer than the requisite number of record holders.

And it turns out, by the way, that record holders is actually just based on a formal requirement of who is showing up as a stockholder record on your books. Most shares are held in indirect form, so it turns out that those number of record holders bears almost no relationship to the number of beneficial owners.

So the number of record holders of General Motors, for instance, is a staggering 275. Okay. So if it turns out that if General Motors decided to delist from the New York Stock Exchange, it could go dark tomorrow, okay, because it has fewer than 300 record holders, which is all that's required in order to file a Form 15 and go dark.

Okay. So in any event, though, this is the

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method that you do it, is that you would get off the

Exchange, and you have fewer than the triggering number of shareholders.

Now, you can't raise any money because if you want to raise any money, you're probably going to be subjecting yourself to Section 5 of the '33 Act, which requires registration. Okay.

But if you're not raising capital, as many firms aren't, you can delist and you can stay underneath this 300 shareholder record and you can be fine.

Now, your selling shareholders are also subject to registration requirements, which could force them to come up with a disclosure document. But it turns out that the selling shareholders, reselling shareholders and the dealers that work with them are going to be exempt under some exemption to Section 5, which is known as Section 4(1), 4(3) exemptions. So you can do it.

But that doesn't mean that you're not without disclosure obligations. Why? Well, because you get one great thing by being subject to all of these -- sort of this onerous Section 13 reports. In exchange for subjecting yourself to the conflict minerals disclosure, you get federal preemption of state law. Okay. And that comes about through something called Section 18 of the '33 Act which says that if you are trading a covered

security, then the state, they can regulate fraud, but they can't regulate the disclosure documents that pertain to you. And that's really important to understand, because it turns out that each state has its own separate securities regime. They're called Blue Sky laws. They work just like the federal regime. They basically enforce disclosure obligations and they police fraud.

Okay. So if you are a company, you have shareholders across the states, as many companies that raise capital in our marketplace do, you have to worry about complying with potentially 50 different state regulations. This is a huge mess. It's been a long mess ever since Blue Sky laws sort of were developed in the early 20th Century. It became a special mess when we then had a federal regime in the 1930s.

So you had a dual regime where you had to comply with the federal regime and the 50 different states. It was such a mess, in fact, that Congress said, let's clean it up and create one standard, the federal standard. This would happen in 1996 through something called the National Securities Market Improvement Act and basically created Section 18. Okay. So as long as you're trading a covered security, you only have to comply with one disclosure boss, and that's the

federal government.

And the way that it works, it says if your securities are listed on a major stock exchange, it's a covered security.

Alternatively, if the securities are sold in a Section 4(1) or 4(3) resale transaction and you're subject to 13, then you're also going to preempt the state law. Okay.

Now, what happened is that when you have OTC transactions occurring, those companies that are not subject to Section 13 filing obligations and they don't trade in an Exchange, they no longer have the power of saying these are covered securities.

So as a result, these transactions are all going to be subject to the litany of state securities laws that regulate resale transactions.

And so, for instance, here in California we have 25130, which basically says that it's illegal to resell a transaction unless you file a disclosure document. There's exemptions to it, but, as I read the exemption, they are rarely met in a lot of resale transactions that take place in these marketplaces.

So let's just take a look at these exemptions that apply, right. So you're now off the grid. You're at Proxim, right. How does Proxim make sure that

they're not going to get in trouble with the various state securities laws because these resale transactions are taking place without being a covered securities?

Well, there's a handful of exemptions. These exemptions are often mapped onto something called a Uniform Securities Act. It didn't take long to figure out the 50 conflicting securities laws, which are complicated. So the national -- the state securities commissioners did actually try to come up with a uniform system of state securities laws. However, it's just a template. So the states are free to tweak it around the edges, and they have tweaked it considerably since it came out in the 1950s.

But generally, the exemptions try to map onto these three resale exemptions. And so one of them, for instance, says that if you're not using a broker, if it's like an eBay transaction, right, if I just decide to sell a security to someone who is interested in the market without using a broker, then theoretically we won't worry so much about that because it's brokers that we have to worry about, because, as we have heard about this morning, they really get on the phone and try to market a stock, okay, which might be a concern for any number of reasons. So this unsolicited resale transaction, it's going to be exempt.

At the same time, we also have an exemption that says if it's an isolated sort of one-off transaction, even if it involves a broker, that can be -- that can be okay as well, as long as you know -- if it's basically you're just -- you know, house caught fire, you sell your -- sort of your holdings of Proxim securities, it's the only time you ever sold it, we generally allow you a free pass as well.

Likewise, there's always private resale transactions. It's a -- in California, for instance, it says if you sell to an accredited investor effectively, it's also going to be exempt.

And there's also something called a manual exemption, which is incredibly important actually for complying state laws. And what it says is that if you aren't subject to Section 13 and if you want to have an active market in your securities on the OTC, what you're supposed to do is you're supposed to file your annual financials with a recognized manual. And the manual is published by a couple of agencies, which tend to be agencies rating as well as Standard & Poor's. Mergent is one as well. And these are all publicly available and so you're supposed to be able to go and look up Proxim's last balance sheet.

Turns out, however, that it's not perfect

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because this is only possible in 37 states. The conditions for being manual eligible differ in these 37 states. And the manual doesn't exist in certain states such as California, which tend to be a large market. So that's -- that's -- that's one limitation.

And there's one other thing, too, that imposes, while I'm staying with these private non-Exchange Act companies are actually subject to disclosure obligations, is because there's actually a federal rule that applies to a broker-dealer. And it's Rule 15c2-11.

It says that if you want to quote a security that's not on NASDAQ, it's not an exchange, then you have to make sure that you get -- you receive from the company some financial information. It's about 16 items of information. It basically says that you can't legally trade as a broker-dealer quote unless you get these 16 items of information. So they include things from basic corporate details, who the officers and directors are, and some financial information, so balance sheet and a recent income statement. So those are some of the disclosure obligations that apply.

So that's why I contend that these non-Exchange Act firms are in fact subject to disclosure obligations.

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Now, what are the problems with it? Well, first of all, let's take a look at the state resale exemptions, why you might even be uncomfortable if you're a company on OTC being subjected to these requirements.

So the first one is that it's just complex. Okay. So if you represent Proxim and you -- I mean, I would sort of go running and screaming if I was aware that, you know, the company wants to have investors or raise capital across 50 different states potentially.

I feel fortunate that most of my clients were in fact having covered securities, so that I only have to worry about one federal regime, which is complicated enough.

So, for instance, you know, what is an isolated transaction? It turns out that you're going to have to look how states have interpreted that, and they might differ in how they interpret it.

For instance, likewise, has the state complied with the manual requirements, which might differ across different states as well?

What about these non-manual states, like California; have you complied with their somewhat idiosyncratic resale requirements? So it's complex in order to have a compliant resale regime in this domain

or to raise capital across these 50 states.

There's also the question about whether or not these resale transaction exemptions still make sense. And the reason I think that this is something that we might see some movement on recently is that the space that we're talking about here, these publicly traded private firms is growing by leaps and bounds. It's growing very, very quickly. It's going to grow even quicker because of the JOBS Act.

And so this is a period of time where we might see these provisions being tested by state regulators and say, you know what, this unsolicited quote transaction, I don't know if it makes much sense because all of a sudden these broker-dealers are saying they're getting tons of unsolicited interest. Why? Well, because OTC marketplace is online. It's very easy if you're interested in sort of trading, just sort of submit an order that's not solicited just by virtue of the technology of the OTC market today.

So you can see that this might be nearing a time when some of these exemptions might simply disappear. And in fact that has been the case in some of the states.

And so, for instance, the manual exemption has been eliminated in certain states in recent years as

well out of concern that it's really not a very functional way to assure investor protection in a publicly traded over-the-counter marketplace.

And then likewise, I think there's reason to believe that because of the complexity, because of past attendance of only focusing on the federal regime, a lot of companies just aren't complying with these rules. And why -- and here's a quote, by the way, from "The Corporate Counsel" talking about SharesPost and

SecondMarket. These rules all apply to those firms as well. And they say: "Companies on these markets often ignore the Blue Sky stuff; they don't require that counsel's opinions address these matters."

And when I talk with participants in this market, I am curious what these legal opinions cover, because typically you're going to get a resale legal opinion, and they tend to govern the '33 Act and they don't cover state securities law, although I would love to hear whether that has changed over time.

The reason I think that this is problematic is because a lot of these state provisions have the same remedy for violations of the registration requirement that the federal regime is, which is rescission. And so it very well may be the case a lot of people are walking around with effective put options on the stock that they

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purchased in the over-the-counter marketplace, which can create a huge mess in the event that the company underperforms. And I'm not sure that this option is actually being priced in the marketplace, as of course it should be.

Okay. So as I said, these are some of the problems. I think these problems may be -- oh. With the state disclosure, here are some problems with 15c2-11 disclosure. This is not news. This is one of the more critiqued rules that I've seen by the SEC.

Basically some of the problems are it only governs initiation of quotations. So of course the financial information that the broker-dealer gets could get stale very, very quickly.

It doesn't cover at all the situation on SecondMarket or SharesPost, where there's no quotation being done by a broker-dealer. Those tend to be more like -- well, SharesPost claims it's a patented bulletin board. These represent customer interests. There's no quotes there being offered. So it doesn't apply at all in those markets.

There's no public repository of this information as well. So it goes in a file of the broker-dealer. And they have to make it available upon request, but there's no public repository like there is,

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for instance, say, with the SEC.

And then there's a bunch of exemptions that broker-dealers have to the rule, which also limits its effectiveness.

So, for instance, it doesn't apply to unsolicited quotations. This is actually dual-pronged. Pink Sheets actually got concerned that broker-dealers were saying, we don't need to have the 15c2-11 information to quote because we're getting unsolicited interest. Because of course they could realistically say, we're getting a lot of trading interest because of the electronic platform of OTC market.

And then likewise, there's something called the piggyback exception, which basically says that as long as you see the market maker quoting a security, and that security has been quoted for 30 days with no more than four lapses of quotations, you can go ahead and start quoting that security as well without having to get the 15c2-11, even if the original person who got that information has decided to stop making a market. And so you can have piggyback after piggyback after piggyback without anyone knowing even where the 15c2-11 form actually is.

Okay. So not surprisingly, this is -- again, as I said, it's been heavily critiqued. It's been

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critiqued -- and there was proposals actually to amend it in the '90s that never survived. There was a roundtable market structure, a microstructure last October, I believe, where this came up as well as in need of potential reform.

This is -- the CEO of Pink Sheets describes "Rule 15c2-11 is a rule of darkness," as opposed to a rule of transparency.

Okay. So there's some problems, and these problems are going to become potentially more serious, I think, to contend with for companies that trade in this space, the space as well that both Steve and Jeff are talking about potentially to invigorate in terms of the marketplace. I think these legal problems are going to grow.

So to give you a sense, there are 3,000 OTC no-information firms. Okay. I looked in June, and there's about 2,700. 300 more somehow appeared in just the span of a few months. Okay. This is a marketplace that is growing by leaps and bounds. And for reasons that you can probably all understand, because who wants to comply with the conflict mineral rule if you have a marketplace where you have real liquidity without the need to comply with any of the disclosure obligations?

Also, the reason I think that states are

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getting increasingly focused on this space is because they already are concerned. So in response to the JOBS Act, for instance -- here's the President of the National Association of Securities Enforcers. His testimony says we have -- and this is in specific response to increasing the 500 threshold to 2,000, or I think it was 1,000 at the time.

He said, "We do have concerns about drastic changes in the thresholds for reporting companies or the information they must disclose. The primary reason for requiring a company to be public is to facilitate secondary trading of the company's securities by providing easily-accessible information to potential purchasers. The principal concerns for states is the facilitation of this secondary trading market with adequate and accurate information."

So it's already on the radar. Okay. So this is why I think that it could potentially be an increasingly important issue for companies in this space.

As they say, you know, Eliot Spitzer has had kind of an interesting career. I think it might be interesting for me as well to see where I might be able to find some exciting regulatory initiatives.

So, again, it's just a prediction. I'd be

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happy to be proven wrong, but it's something, I think, to take seriously.

So what can the Commission do about it? I don't think doing nothing makes sense. A wait-and-see approach is going to I think potentially be problematic for companies because they're going to have to choose between do I want to comply with these 50 -- you know, these 50 different states and all the complexity that imposes, or do I file Section 13 reports, as unappealing as that is? That's kind of a Hobson's choice. I'm not sure we really want to put companies in that position.

So what I think makes sense is a uniform system of disclosure. I think that that actually facilitates capital formation for smaller companies, again, because it simply makes it easier to see your transaction cost, people understand it. It's good for investors because if it -- if the disclosure regime makes sense, it can help eliminate some of the information asymmetries that we all know drive the need for mandatory disclosure.

So I'm a fan of uniform, a uniform system of law. So all the Federalists in the audience, I apologize.

So there are two rulemaking approaches that you can take if you're the SEC. And as a Committee, I would

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urge you to consider these. I think one is superior.

So one is you could focus on 15c2-11. It's got lots of problems. It's -- you could eliminate the piggyback exemption. That's been proposed already. I can't take credit for it.

You could make the information more easily accessible, have a public repository. That's also already been suggested, so I can't take credit for that as well. In fact, I would urge you to go back to the original proposal of 1998, I believe, to reform this rule, because these problems with it are well-known.

Why might that help? It would help in the sense that at least the problem wouldn't look so dramatic to state securities regulators, right. They wouldn't be able to point to 15c2-11 and say, you know, this rule of darkness requires us to step in and regulate.

However, it's not preemption. It's not a very strong form of creating a uniform system. And so what can the Commission do?

Well, it turns out that the Commission still has Section 18 to work with, and it actually has some rulemaking authority within Section 18 that gives it -- that creates the authority to reach into non-Section 13 Exchange Act companies and say, you need to start
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reporting on a scaled basis if you want to preempt state laws.

Okay. So the way that this could work, for instance, is two ways. One, the SEC was long ago empowered to create a covered security if it was sold to a qualified purchaser, as defined by the SEC. There was a proposal once to say a qualified purchaser is is any accredited investor. That never became a final rule, so this has yet to be defined by the SEC.

So one approach you might consider, if you worry about this, is to say that, well, look, what we'll do is we'll give you preemption, Proxim, conditional on your selling to a qualified purchaser defined as an individual who either has access to information or you provide specified disclosure.

This is actually not a new idea, in fact. This is how we long -- have long interpreted the private placement rule, which says that you can sell to sophisticated investors, but sophistication being defined as either someone who has access to information or someone who has been provided with requisite disclosure documents.

Okay. So you can simply say a qualified purchaser, just like we use -- do in the 4(1) -- or the 4(2) jurisprudence. We say that if you sell to someone
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who has access like a venture capitalist or someone who doesn't necessarily have access, like a retail investor, but you give them a disclosure document that has an appropriate amount of information, certainly not all Section 13 information, but maybe something that's scaled appropriately for an over-the-counter company, then you can get federal preemption.

An alternative approach as well is to say that covered security includes a security sold in a resale transaction under Section 4(1) or 4(3), which is most non-insider resale transactions, if the company files Section 13 reports.

So one approach is to do what high yield investors do, is they say, we know that you're not required to file Section 13 reports, but you can always voluntarily file Section 13 reports. And so one approach is to simply use that model and say, what we'll do is we'll create a special set of Section 13 reports that are only eligible to be used if you create the right classification of a company.

That might be one of these companies that Jeff was suggesting, that sort of -- you know, a small tech company that doesn't trade on the New York Stock Exchange. Or another criteria that indicate that we're really trying to focus on the eligibility.

To use these forms, you have to be like Proxim, a company that doesn't want to be subjected to Section 13 but trades in a public marketplace.

So if you do that, they may then voluntarily choose to file these sort of lighter forms of Section 13 and then claim that the resale transactions are exempt because they're done under 4(1) and 4(3) and we are voluntarily filing Section 13 reports; and so, therefore, these are covered securities.

So those are two approaches I think that make the most sense because you get federal preemption. And I think this is sort of, at least in my mind, an issue that is going to increasingly become a problem for small and emerging companies that operate currently in this unregulated space beneath, well, 2,000 shareholders as of today. So that's all for that.

MR. GRAHAM: Thank you, Bobby.

Couple more minutes before we break at 3:00.

Any more questions for Jeff or Bobby?

(No audible response.)

Hearing none --

MS. JACOBS: Yeah, why don't we take a quick five-minute break, and then we're going to open up for discussion. And, please, as many members as possible hang around because this is where we're going to need

y'all.

(A brief recess was taken.)

MR. GRAHAM: I'd like to get started with the discussion, kind of our -- kind of our discussion part of the afternoon. Surely, it's one of the more important parts. I wish that we had more time for it, but we don't. And I also understand that there are a number of people that have planes to catch, and so - -I think maybe before we actually conclude, so I want to get started and give everybody an opportunity to weigh in a little bit.

Again, so going back to what we said this morning, the purpose of today was to look at two general areas and think about what kind of recommendations we can make with respect to those areas that would help further the interests that we're trying to further as a committee.

Those, of course, are the structural issues that we find in the marketplace, number one, and, number two, the scaled disclosure.

You know, I think what I would -- what I would like to do is have a conversation. We heard -- we've heard a lot things today. I think some were kind of more interesting from kind of a broader -- kind of a context point of view; I think others more directly

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related to what it is that we're trying to accomplish in terms of coming up with specific recommendations.

So what I would like to do is begin the conversation and, at least before we break, have a sense for where we feel we should be headed as a committee.

If one or two specific recommendations fall out of the discussion, great. If not, that's okay too. But let's begin the discussion. And then I think what is likely to happen is that following this meeting we will -- you know, Chris and I will think about what we've heard and begin to kind of draw some recommendations into focus that we've been discussing to help finalize.

Before we kind of open it up for discussion, I think Chris has a couple of things she would like to say.

Is that true?

MS. JACOBS: Yeah. Just to begin to set the stage for the discussion, we've spent several meetings on the IPO Task Force, the IPO on-ramp. And as we begin the discussion this afternoon, maybe ask y'all to change momentum here a second and look towards day two.

The one thing I know, as a sitting CEO, is you don't ever create or set up with your company with your

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IPO as your end game. Your IPO should be the beginning of your next step. And that next step and what that environment entails for us is what we need to discuss today. Because the environment for these public companies, day two. Once the IPO is finished, we have a set of rules and regulations that are well documented as being a burden.

Professor Schwartz, I'll probably be putting you in my will sometime next week because you hit a lot of the points that I think we -- I'd like to see us cover.

And I would like to hear whether you're an investor. And maybe as investors, y'all don't have a dog in that hunt, but to those of us that are associated with small reporting public companies, there's a lot of reform that could be done now that's not quite the burden of perhaps a new set of markets. Because we've got that -- let me give you an example.

We've got the $75 million market cap as the hurdle for exemption. Well, as you brought up, Professor Schwartz, why is that 75 million, when the JOBS Act has given a hurdle rate of a billion dollars in revenue and five years of reprieve? There is a real disconnect here.

And so all I wanted to do is sort of set the
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stage on what we were hoping we would hear from you this afternoon about scaling and that day two for these public companies.

MR. GRAHAM: One last maybe point of order, how would you guys like to manage the discussion? I would like to hear from everyone.

MR. SUNDLING: Free flowing.

MR. GRAHAM: Would you like to comment on both scaling and the kind of market issue, or shall we spend a half an hour on market issues and then switch over to scaling?

MR. SUNDLING: I think it depends on who's speaking.

MS. JACOBS: Yeah.

MR. SUNDLING: And -- yeah. If you don't -- I don't know what everybody else thinks, but I think that the opinions and the things that people might want to talk about are going to differ depending on your background, what company you're representing here.

MR. GRAHAM: Oh, absolutely. I don't disagree with that.

So why don't we just kind of start with maybe the structural issues, and some people have more to say on that and others less, and then we'll move on to the subject of scaling, if that's okay.
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So we've heard a lot about tick size, whether that matters. I guess what I'd like to do is, again, just kind of open things up for discussion, think about what we might want to say about that as a committee.

Does anyone want to start?

MR. SUNDLING: I'll start, if you don't mind.

MR. GRAHAM: Okay.

MR. SUNDLING: But if you don't mind, I'd like to back up just a little bit.

So first of all, the speakers and presenters here today have been phenomenal. Thanks for your participation. I know I learned a lot, probably a lot of -- you know, there was a lot of information there that I don't think I absorbed today, maybe never will. Some extremely deep expertise from David on the way the trading markets work and from the professor on kind of the observation around -- you know, I saw a lot of analysis done on just charts of what the markets are doing.

But I think, you know, if we back into what's the charter of this committee in looking at capital formation is one problem, and a form of capital formation is going public, right. So you go public to raise money, and then, you know, as Christine said, then what's your Phase II once you are public?

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And so coming from the angle of a sub $50 million software company, right, so everybody -- we got investment bankers here, we got regulators, and folks from the academic world -- from my perspective, if you -- and I belong to a lot of groups, right, with a bunch of other CEOs that are in the same -- probably in 100 million and below software space. You don't even talk about IPOs anymore, right.

It's -- and I think we have to realize that, for all intents and purposes -- you know, I keep thinking about the regulatory changes they're talking about. That's akin to kind of just bumping this can a quarter inch at a time, and it needs to move five feet, right, to really get people excited about the objective of becoming a publicly traded company.

There's got to be radical reform, not just around regulatory requirements. But I think there's a marketing problem, right. I think that if you turn the clock back to 1996, the only thing anybody ever talked about was the IPO.

You talk to any of these CEOs, and we're -- you know, we're trying to extrapolate from these market statistics and all these other things what they might be thinking. It's easy. Just survey them. Call them. I talk to them all the time. And I am one of them, and we

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would never consider an IPO.

And with all due respect, right, if the idea is to figure out -- you know, all the things that I even heard in the last few hours and then in prior sessions is you're not selling me on going public, that's for sure, right. It's --

MS. JACOBS: Why is that, Charlie?

MR. SUNDLING: Well, I think just -- it's just -- it's difficult. And when you look at the exit options, you always have to see what is the competition. The competition for liquidity is M&A. The M&A market’s red hot, right. It's not hassle-free. Nothing is. But really compared to going public, it's an easy way out. You've got investors.

You know, when Steve was here, I think it was he who made the statements from a VC perspective, right, there's kind of two things they look at. One is in the initial discussions, who's your buyer, you know we're going to put money in you, who are the most likely buyers, which is a very fair question.

And from an IPO perspective, it's -- I think he said a hundred million in revenue or bigger, and market cap, you know, day one IPO, nearing the billion dollar mark, before you get any, you know, of the A player anyhow, i-bankers involved in your deal.

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But I think the perception that I have, and I spend a lot of time, and I realize the complexity. We do a lot of complex stuff in our business, right. Our customers are very big global energy companies, nuclear power producers. So everything we do is complicated.

I'm not afraid of complicated. When I look at what it's going to take to go public and remain public in all those -- you know, until you reach a very substantial scale, it's not even the money, a million bucks a year, whatever, to pay the auditors and all that. It's more the risk. It's the distraction from your business. It's the fact that, from a liquidity standpoint, it's a lot easier to get a big check from a strategic buyer, right.

And so I think in looking at -- so there's the two things that we've maybe been -- the two big things anyhow brought together to discuss is access to capital, and then somewhere along the line this whole discussion about IPOs came in because I think it related to access to capital, as far as I can tell.

And then you get into the systemic functioning of the market, right. So on the trading side, right, the things that David brought up about, you know, the spreads and on, you know, the decimalization and all these things that are kind of impediments to that side

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of the market.

You combine that with kind of the -- you know, this whole notion of what still sticks in the minds of every entrepreneur I know is when Sarbanes-Oxley came out, you wrote off the IPO thing. It's not even really talked about. And it comes up once in a while, but it's really -- you know, if you've got a business model that's a potential rocket ship, like a Facebook, you know, the other dimension. And you really got to get into the details.

I would really recommend that in the research that's done you -- there's -- you drill down into some of the more detailed aspects of this round of psychology of the CEO and the board and the VC, then map it across, you know, all those metrics over the years.

And I would bet one of the things you find are things like, you know, the -- depending on what market you were in, if you were in the B-to-C world, well, you know, that's something where you can go public, you can remain independent, and you could have a grand slam because you're selling to an emotional buyer, right. You look at the IPOs, Facebook, LinkedIn, Groupon, they're selling to an emotional buyer, to consumer.

If you switch over to the B to B world, right, if you're an enterprise software company or a SaaS

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provider, look at the competition, and your likelihood of surviving as an independent company and growing and getting anybody interested in your stock, right, and I think what you find is there has been massive aggregation in the tech space. There's going to be ten big companies left on the planet at this rate, right. Most of them have acronyms for names.

And at the end of the day, right, if you are going to remain independent, those are your competitors in the B to B world. Our smallest competitor has a $64 billion market cap. That's the small one, right.

So can we compete with them? Not over the long-term, right.

Well, what we and most of the CEOs I talk to that are in this kind of boat, what they do themselves is outsource R&D for big companies, right.

What we're trying to do is build a product and out-engineer them, get it to market. Can we ever compete globally when they dominate the channels of distribution and all the servicing integration partners? No. Right. All you can do is put yourself on the tracks, right, and hopefully get a bidding war going between a few of them that all want that piece.

I think it'd be really interesting to map all these charts against the M&A in the growth of these big

companies.

Again, in our space, you know, if you look at the big companies in this -- and I think someone mentioned a recent IBM acquisition in this group. Just look at the size and scale of these companies. On one chart where it said what are the impacts -- the impactful items to people wanting to go public or remain public. One of them was this -- it was -- I can't remember the term, but it was about the scope, the example that was given earlier about the refrigeration truck, right, the ice cream and the milk.

I think -- and that was rated as not important. I think that is massively important, because out there in the competitive world, what happens is you have a product that -- and you look at profitability. So this chart that shows small companies aren't profitable. Well, yeah, because you have to fund overcoming that channel dominance and effective monopolies of control in these customers in the B to B world.

I would suspect that's not true when you look at consumer-oriented target markets, although in some it may be true.

But absolutely in tech, B to B, it's all about distribution, right. And those are very tightly

controlled quasi, almost cartels, right, that used to -- what was the saying, right, you don't get fired for buying IBM. Well, you don't get fired for buying HP, you don't get fired for buying Dell. Right. You could get fired for buying Pipeline, because nobody knows who we are. We're very specialized and, in our niche, the best at what we do.

But there's a very kind of dominant evolving market of really big companies that nobody wants to compete with. You certainly wouldn't want to go public and get hammered for a couple of quarters. And when you look at what your marketing spend is to overcome some of these distribution channels, that's why the profitability is low.

So bottom line to me is -- and again, you know, I don't think it's a Charlie-ism. I think it would be great to, you know, let's do a survey and talk to all these people and they'll say the same thing, is you're crazy for going public, right. You built some value, try to lock down a patent or two, get a little bit of leverage, and then you sell.

MR. GRAHAM: Now, when you say you're crazy for going public, how would things have to change?

MR. SUNDLING: Well, so that's a great question. And I've been -- and I'm trying to remain

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optimistic, believe it or not, and trying to think what if, again, someone was trying to convince me to go public, what would have to change?

And, you know, it's actually pretty tough to say because I think that the fundamental market has changed and your chances of survival in a public market, it depends on the size of the company. If you're sub 50 million, one of the great things about being a small private company is you don't have to tell anybody what our revenue is or what anybody is getting paid, and all these things that competitors are going to pull right out of your Qs and Ks and use against you, maybe even customers will. Our customers are very, very large companies. You know, so there's the dimension of disclosure and risk, right. So you put financials out there for the world to see, again, depending on what kind of shape you're in and what you're trying to do, you may not want to do that.

What would need to change, right, is -- it's probably a whole bunch of things, but at the end of the day, they all add up to risk mitigation. If I were to go to my investors and say, hey, I want to go public -- I mean, I don't even know how that story could be sold, right, because the other thing that's happening --

MR. GRAHAM: Certainly not in today's

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environment.

MR. SUNDLING: Well, you can't. And a big part of that reason is the lucrative nature of M&A, right. So the private company deals that are getting done, the volume of them, the multiples being paid by strategics. You know, unless you think you've got something that's going to be a 20-year business, right, and exist in perpetuity -- which I think is not in the mind set anymore, right.

And I can remember the days, right, and I'm sure y'all do as well, that the only discussion ever was about building a great company that's going to last a hundred years, and it's going to be billions. And everyone was, you know, drinking the same Kool-Aid.

Well, Kool-Aid these days is, right, highly leveraged investments that even VCs, they're doing these tiny rounds. They want to just see proofs and technology, very incremental, and they're looking for the tenbagger that might be under a 50 to 100 million dollar total deal, right, which means total investment is going to be 2 to 10 million.

That's the other thing that we're seeing is, you know, the -- other than the very rare, exceptionally large transactions, that lower end market is really research for big companies, right.

One of the -- I mean, one of the potential theoretical remedies to the whole thing is what was discussed earlier, which is just a completely different alternative market, right.

The one that I used to follow that was interesting is this whole London AIM thing. I don't know if you guys pay much attention to it. But I remember some British bankers telling me, yes, just the public venture capital, right. Is the reporting -- you report once a year. You get this thing called a nomad, who's your nominated advisor. All the requirements are very low. And everybody knew that effectively this thing was just a way to raise money. Easy, very low regulations, didn't distract you from your business, and gave you some kind of liquidity.

It's not, you know, an actively traded, you know, volume traded stock to where all the investors are liquid, but now you've at least got a vehicle where you can bring in institutions and other things, and founders can liquidate some of their stock. So some kind of alternative vehicle, maybe a modified version of the OTC would be interesting. I don't know.

But, you know, I think in the U.S. in general, nobody would argue that we really kind of put the regulatory screws to all of this. And now it's got

to be spun back. But even after they are, I would argue it's a five-year marketing job to unwind it, right. So is everybody prepared for another decade of slow small cap IPOs? Because I think realistically that's probably what's going to happen if you fixed it today.

MS. JACOBS: I didn't hear. I want to make sure, though. I did hear you say that the regulations are as much an impediment as market structure?

MR. SUNDLING: Yeah. I think there's multiple -- yeah, regulations, market structure, and whatever you want to call it, the change in psychology of the executives and to some extent the investors.

MS. JACOBS: Right, the macro.

MR. SUNDLING: Yeah.

MR. GRAHAM: Okay. David, I know, has got to leave pretty soon.

So before you do, anything you want to say besides goodbye?

MR. BOCHNOWSKI: It's been a great day. You know, the evidence that we saw is that there was a period when the IPO market was something everybody wanted to do. Clearly we're not going to go back to that time. There's no way to change things that have occurred.

I believe that Professor Schwartz, he'll be in

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my will, too, because I think at least he's given us a path to whatever the future is going to be. I think we have to think about what that future is going to look like.

Many of these issues don't really directly relate to me as a CEO because I'm a community banker. Where it does relate is that we know that the IPOs created more jobs over time, and that gets back to what I do every day. And the more jobs there are, the happier bankers are.

So I think we've got to figure out a way to come up with a new regime, and I think that's what you're suggesting. And we've got to create whatever that future is so that the economy can continue to thrive.

I thought that one of the things I learned today was very instructive to me, and that was when you shifted to the electronic order book. Where that discussion impacts me as a company is that every time our stock has been slammed down -- and we have an average volume of under 200 shares a day -- it's always happened electronically, never happened through the book.

And so I think there is that investor class and there's the trader class. The trader class is not

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helping what we all do every day. And I think that has to be addressed.

On scaling, clearly the idea that my company or any company that is of our size has to report at the same level and do the same things every day that the very large companies that do offer systemic risk to the American economy and to investors is the risk management portion of this that I think we need to address as a group. And we have to be sure that the risks that some of us take on and the rewards that some of us have for taking on those risks are scaled appropriately to whatever might happen within the economy that would be a negative to the overall status of our nation.

But some of us clearly don't offer those systemic risks and shouldn't have to go through the same things as those who do. So that's why I applaud what you -- the seed you have planted.

MR. GRAHAM: Milton.

MR. CHANG: I think we're not going to roll the clock back. I think if we can fight them, I think we should think of ways to supersede them.

My prediction is that the IPO market is going to continue to be in bad shape for the foreseeable future. Because if you look at the feeding part of it, in terms of where VCs park their money, is mostly in the web and

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mobile space, where tends to be very -- just very little product differentiation where the ticks are off. And you're going to have very few IPOs for big ones. Where on the manufacturing side, product side, there are room for differentiation; therefore, there are many IPOs.

So I don't think that's going to be changed in the sense that's the investment trend on the feeding end.

And I think the objective is about job creation and economy. And if that's the case, M&A is probably just as efficient, if not more so, than IPO, because scaling is much more efficient in a big corporation.

So M&A in fact is a very efficient way of scaling the businesses once it's incubated in a small company.

And I think the capital formation is really the key to growth. And I think that's in fact the charter of the SEC.

And I think two personal experience that's not being discussed: One is the -- in the good old days you can walk into Cisco and you say, I want to develop this technology. And you can come out with an agreement where you will be bought when your objective is accomplished. And you use that piece of paper to go out

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and raise money.

That can no -- that's no longer allowed because that's kind of external R&D funding. So you have to write it off on your bottom line. And that's a detriment to -- in terms of getting VC funding.

And then the other one is the allocation of the R&D tax credit or tax loss. Those are great incentives to attract investment capital into the startup community, and both of those are gone today.

So I think those are the systemic issue that we can really sort of recommend to make a difference.

MR. GRAHAM: You know, this -- you know, we talked about scaling. And it relates directly to capital formation because we've got companies -- I mean, there's a bigger hurdle than that, you know, with companies like Charlie's who say they don't want to go public. Nonetheless, that is -- that is a -- that does provide headway for people who do want to at least consider the IPO.

Then in terms of -- we talked about capital formation, and kind of related to that is that if I can save a million dollars in compliance costs, that's a million dollars I can use in my company.

And it really -- you know, it really seems to me that -- that when you think about how you can

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accomplish this, that more and more we should be thinking in terms of the principles we apply in this context. Because it seems to me that kind of a basic, you know, tenet of what we're dealing with here is disclosure and what is and what is not material. And it seems to me like that materiality doesn't necessarily depend on market cap or revenue or how long you've been public.

MR. CHANG: I think I'm in 100 percent agreement with Charles. What he essentially said is take it one inch at a time, five feet at a time. That's the back end. The front end is the capital formation.

MR. GRAHAM: Right. But my question is in context for anyone to respond to, investors in particular: What is out there in the way of compliance that you see that you don't need?

MS. JACOBS: Here's a question: For those of you that invest in public companies, is the disclosure in and around conflict minerals going to be material? That's a simple one, I think. But you have to tell me or -- because we had this discussion several months ago when we even discussed the CD&A, pay-for-performance, the frequency of pay-for-performance. I mean, the list goes on and on.

MR. CHACE: I can tell you that the way we use

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public documents, the research companies, the 10-Ks and the 10-Qs, for the numbers, for the business description, for the footnotes to financial statements, the management discussion and analysis which I think is relatively straightforward.

(Outside noise.)

The compensation disclosure is much less. I think it's really (inaudible) put together. It's not an area where we typically focus -- I can't speak for every investor, obviously, but I think that we spend a lot of time talking about it, try to gauge their motivations from that. Compensation is a part of that. It really is (inaudible). We're looking for people that are founders, inside owners as well. (Inaudible) complex pay structure. Conflict minerals is (inaudible).

MS. JACOBS: Okay. So we got one.

MR. DENNIS: I think the question on the conflict minerals is, that's in the law, right. Congress wrote that. It wasn't written for customer protection.

I think the question is to the SEC staff: Do we have any flexibility here? Because the law is pretty clear. As I understood it, it said you will do this. And so does the SEC staff have any ability to exempt companies under a certain size? I don't know the answer to that.

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MR. NALLENGARA: The final rule, which was adopted late last month, didn't exempt any company. And the reason for that is expressed in the final rule, is that the congressional mandate in Dodd-Frank didn't provide -- didn't contemplate anything other than all reporting companies have to do the -- have to do disclosure. There is some phasing provided for smaller companies.

MR. DENNIS: You know, it's like a four-year --

MR. NALLENGARA: Four-year.

MR. DENNIS: So we got four years to get Congress to change the law, kind of how I --

MR. NALLENGARA: Well, it's not really four years. After doing four years, they don't have to -- you know, there's a varying -- without getting into -- and I think we're all in painful detail of the rule, there are some variances, there are some stages of work that a company would have to do. Whether you can certify and get an audit saying that your stuff is conflict-free is at one end.

And a smaller company can for four years effectively say they haven't been able to determine whether it's conflict-free. So it's still work for them to do, but it's a part of -- it's part of an elaborate

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transition mechanism, smaller companies have a longer transition.

So I mean, this is -- and I don't think anyone, at least -- I'm from the staff perspective, I think the Commissioners, I don't think anyone is thinking this is disclosure that an investor determining whether they're going to buy or sell its security is looking for. This is not that. This is -- I mean, that's not what the purpose -- I don't think that's what the purpose of -- if you look at Dodd-Frank, that wasn't the intended purpose.

So when you look at materiality, it's probably not the best lens to be looking at this Act, because I don't think that was the lens that anyone who --

MR. DENNIS: But I think it does show a

dangerous trend of Congress using this organization as a way to social engineer something that is not in its mandate, not in its charter. And I don't expect you to comment.

MR. NALLENGARA: No, no, and I'm grateful it's not webcast, so --

MR. DENNIS: We can make a recommendation that -- maybe the recommendation, Christine, is that we try to seek congressional action on this in some way. That's probably the answer to this. Maybe that's how we

form our recommendation.

MS. JACOBS: Well, okay. That's one suggestion. But then I'll throw another one out to the folks that are investors. XBRL.

MR. CHACE: I am not certain how much we use it directly. I mean, the word -- and we use basically the filings to plug in our own numbers. It's not clear to me how XBRL makes my life better. We do use a lot of financial information providers that probably benefit from XBRL that we use to download data. So they have some secondary positive effect on us, but not day-to-day.

MR. LEZA: Can we get back to jobs, get back to access to capital, which is basically why this group was formed for. I like to separate it in two ways here to make a comment, one from the private side, and one from the public side.

From the private side, I was involved in startups in six companies. One of them failed, five were acquired in M&A. Okay. And there was three things that you looked at. And the animal has changed from IPOs, the way I see it.

Okay. The first thing you look at, risk. You look at risk. And you kind of evaluate what my options are going public or what my options are going M&A.

The second thing you look at is, what kind of money am I going to get based on IPO and based on M&A?

If you look at it, M&A has been swinging to where they used to have a multiple one or two, and now they're paying seven or eight. Now, so you kind of look at it and say, I mean, I can get seven or eight. I'm not tied up. There's no locking. I can -- my stock can be, you know, liquid in no time. And since it's a big corporation, I can sell immediately because I don't hold that much of a percentage based on the large corporation. So the animal has changed from the private side.

So a lot of the companies that you see, they look at risk, they look at how much money.

And then the other problem that they look at, and I think this is one big problem, is all of a sudden you've got two things. From the private side you go in and you look at it, and all of a sudden it becomes performance quarter to quarter. They don't care about the long-term. It's quarter to quarter. And people do not like working like this. When you're private, you're looking at three to five years, and you're making decisions in three to five years.

And this thing about, I need to be looking at it quarter to quarter, you spend so much time doing that

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and trying to see what you need to little tweak and stuff. And you look at this and say, hey, it's a choice here. It's not that -- you know, I can understand some of the presentations and some of the stuff, but I think the pendulum has changed.

From the public side, being involved with public companies and market cap all the way from I would say, you know, 70 million all the way to 450 million, you look at that from the private side.

And I can understand SoX, you know. And like I said before, when we implemented SoX, for the first two years the expense went up, and it went up quite a bit, you know.

But then within the next two or three years, there was certain things that were implemented, and we brought the cost right back to where it was before. Okay.

So I don't think that that is something that prevents things from creating a bigger company or adding jobs or stuff like this. I think regulations, yeah, they're an irritation, but I don't think that that's something that keeps the people from thinking differently.

I still think the focus -- what becomes important is that access to capital. I need to get more

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money to do more things. And a lot of times what happens is you're in the public company, you've gone public and you've got money, and it depends how you look at it.

In a semiconductor company, we had a company that was sitting there, we were growing double digits, but -- you know, and we had $250 million in cash and we were doing something like -- our revenue was like $80 million, and, you know, we were public.

But then another company came in and said, look, if we consolidate, we can buy and do this, do that. The numbers were right, so we said, okay, let's do it. It's not that we didn't want to be public; it's just that the economy and the choice became greater by consolidating and selling out.

The thing that we have to look at is that both private and public companies create jobs when they have access to capital, and I think that's the thing that we gotta look at more closely and see what we can do to relieve some of the constraints so that people are more freely picking up capital and being able to grow in a faster rate than we can have.

MR. GRAHAM: Right. Can't disagree with that.

MR. SUNDLING: I think one of the key points in there if I can chime in that I think that can't be

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lost in this discussion is those multiples and how it's swung. So I remember -- this is not being webcast, right?

MS. ZEPRALKA: It's being recorded.

MR. GRAHAM: Recorded.

MR. SUNDLING: Oh, it's being recorded. Oh. Well, then, I won’t go through that example, but --

There was an event back in around the dot-com boom days. And, you know, we had an offer on the table. And at the time, right, it's exactly what you said, is M&A, the multiples were pretty modest. You know, there were 3X, and there were -- there were, though, these ridiculous dot-com deals happening.

But on the M&A side, you could expect a reasonable return, but there was no limit on an IPO because you'd have -- and there were a couple companies -- won't name their tickers, but one of my favorites had 63 million in revenue and a market cap was $16 billion, right. And so everybody -- you know, we all knew deep down that wasn't going to last, but that's what you were going after.

Now it's all about the alternatives. So, you know, we had some nice offers, and we turned them down, which today, these offers would be -- you know, you'd jump on in a second, right. But it was because of the

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alternative opportunity and an IPO was worth the risk and all the other things that come with it, because it was just ridiculously different what you could do if you had a successful IPO you -- taken out early.

And that's changed, right. So now it's more about those multiples are up, because look at who the buyers are. Just check the balance sheets of all these big -- they're sitting in aggregate hundreds of billions of dollars in cash looking for something to do. They're all on buying frenzies, right. They're taking all the components they need to grow these massive companies.

And on the other side, you've got this crazy, regulated, painful thing called being public. You know, it's a pretty easy choice, right. And so I'll leave that one alone.

I promised Lona I'd complain about one more thing before I left, which is this accredited investor. Okay. Time to do that? Just so we can get some specific recommendations.

MR. NALLENGARA: Sure, yeah, any -- yeah. More complaining is good.

MR. LEZA: With recommendations.

MR. NALLENGARA: Yeah, yeah, if you're going to complain, yeah.

MR. SUNDLING: Around 506 which -- so the good

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news is these reforms around 506 are phenomenal, right. To actually be able to tell somebody that you're selling stock, that's pretty good, right? And we did a PPM and we had to go through all this stuff, and then you get to this notion of accredited investor and who is it. And whatever the -- 200,000 now a year, expecting it for the next year or a million in net assets exclusive of real estate.

MR. NALLENGARA: Of your house, your home.

MR. SUNDLING: Of your primary residence?

MR. NALLENGARA: Yeah.

MR. SUNDLING: Okay. So the measurement you're looking for is a sophisticated investor that can evaluate risk, right. I think nobody would argue that just because you have a million bucks in the bank or you make $200,000 a year doesn't necessarily make you a sophisticated investor. And if there are a lot of people -- you can have a Harvard MBA graduating that's making, you know, 90K doing some analysis work down the road that knows more about your market and your business than anybody else on earth, and you can't take a $10,000 check from him, it just doesn't seem like that's the measurement, right.

That maybe these things were thrown out there because somebody needed to -- you had to have some kind

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of measurement, but what can we do to ease that? Because when you talk about -- someone in here mentioned, I think it was this young man here, cutting off access and limiting investment to certain people. I would argue --

MR. GRAHAM: You can still take money from that Harvard professor, you just can't rely on Reg D.

MR. SUNDLING: Okay.

MS. SMITH: He can be part of your crowd funding.

MR. SUNDLING: Yeah. So anyhow, some look at making that a little smarter on identifying what exactly is an accredited investor.

MR. GRAHAM: Okay. I want to make sure everyone has a chance to comment before we run out of time. I haven't heard from Karen or Catherine or Kathleen.

MS. MOTT: I just wanted to just maybe summarize what I thought when I read all this material and after listening today is that I think there's an amalgam of factors that are contributing to the issues we're dealing with in the marketplace. And obviously things need to be addressed.

Where I see critical issues in my industry, because we're at a point where we invest -- we expect VCs to follow on and invest in some of our companies.

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And in the two areas are life sciences, biotech, I put them together, and clean tech that are very capital intensive. They're going to require VC money.

And when you have a contraction of the industry, what we're seeing is that a lot of these companies aren't getting appropriately funded, and that could really make a difference because there's no incentive, the IPO incentive has been taken away. Or not taken away, but it has diminished.

So we have great concerns about when we're making our investment decisions, wow, this is clean tech, maybe we should not invest in this because we don't think we're going to get the follow-on funding that is going to be required for this company.

So my concerns, of course, are how much that's going to impact those kinds of companies.

And my other concern is something else I'm seeing, is in the M&A market. One of our local companies got 40 million in VC funding, was acquired by -- it was called Renal Solutions. It was a home dialysis kit. Acquired by Fresenius in Germany. Fresenius shelved the company because it was going to disrupt the marketplace. So they paid $200 million to shelve it. So it didn't create jobs, some people made some money, and it made no difference in the marketplace. So, and it

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could have made a difference in people's lives. So that's a concern.

My third concern is we can't be sitting here with blinders on and not be concerned about what's happening in China, people with lots of money. And I was at a demo, a demo day in my own little town of Pittsburgh, and there were representatives from China there looking to invest in companies and build these companies. And that surprised me because we're not Boston, we're not Silicon Valley.

So let's say they find a Charlie, Charlie's company is going to China. Who's going to create -- the wealth that's going to be created is going to be in China, not here, you know, not in my backyard, if that happens. So those are the kinds of things I'm concerned about if we do not address the IPO market.

MR. GRAHAM: Kathleen.

MS. McGOWAN: I just wanted to talk about life sciences and the biotech industry. There are two sides to the story: to stay private and then to look for an M&A transaction. When you're talking about developing drugs, you're talking about clinical trial studies, which could be hundreds of millions dollars. And then you've got a lot of big pharmaceutical companies. And their R&D organizations have been shut down, so

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purchasing of -- M&A -- of smaller companies with certain expertise is the way to go and the ability to buy them.

So IPOs may not always be an exit. You know, you may not raise all the funds you need to continue clinical trials. It may not be even an exit for the current investors, but, you know, that might be one way of -- one way that's stopping some of the IPOs.

But I still think that if you could potentially get an IPO in the market, raise some money, get some big milestones and possibly do a secondary, there's another option of getting additional funds, and then other funding to fund your clinical trials is another option.

I think a lot of the JOBS Act will help with reducing some of the required reporting. Because you have to think, some of these small companies have less than 20 people. You can't possibly get all the reporting and all the things up to speed. Yet they still may have a lot of controls in place already to make it, you know, a viable company and to, you know, be reporting similar to what you need to do, which does not have all the head count required and the cost associated with it. Like you said, you know, that money can go into R&D or additional clinical trial, which is to go into reporting.

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And then I just had some questions on the tick, the size of the tick, which -- size that David was mentioning in, you know, the pilot program and how do you go ahead and do the piloting.

Are the back office operations able to handle -- like if you had two different markets and how you would handle different tick sizes in those markets. Kind of getting the - devil is in the details in how would those things work. Those are things I'm not familiar with. So those would be questions that I have.

But basically, you know, you have private markets and potential M&A exit and then IP exit -- IPO exit, what those possibilities were. And if it would help smaller companies get into the IPO market, potentially raise additional funds to do clinical trials, I think that that's well worth the effort. But I still have a lot of questions after everything today on, you know, how do you go about doing that.

MR. GRAHAM: Well, the good news is that this committee only has to make recommendations.

MS. McGOWAN: Right. And I don't know a lot of that. Some of the things David brought up, I don't know some of the back office of how you physically do these things. Are they almost more -- you know, I don't know the logistics behind it.

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MR. GRAHAM: Right, right.

MR. DENNIS: Steven, on that -- at one point we talked about making a recommendation on the high tech companies with very simple operational structures, but large market cap structures. Is that something that we're going to --

MR. GRAHAM: I'm sorry. I'm not recalling.

MR. DENNIS: Okay. Maybe I'm thinking of a different group or something. But, you know, I think -- you know, we've exempted Sarbanes -- we've exempted small companies from Sarbanes-Oxley. And there's this group of companies that are high tech, large market caps and very simple operational structures that are not exempted from SoX 404, and does that make sense to recommend something around that?

MR. GRAHAM: I'm not sure if we discussed that in this group, or if it was one of the times I was sleeping.

MR. DENNIS: Okay. I'm sorry. I'm brain dead. I must have thought about it -- it must have been somewhere else.

MR. GRAHAM: But I do think that one of the things that we have to be thinking about in terms of this recommendation is kind of the way things have played out where now we have -- we have -- you know,

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people essentially kind of acknowledge that the scaling can be a good thing. I mean, it's going to make sense in a lot of contexts. And that's given us smaller reporting companies portion of money. And it's given us the emerging growth company.

But, you know, within that are, kind of overlooked, kind of orphans I think in this whole process, are the companies like Chris's company where it doesn't -- it doesn't qualify for any of this stuff. But if she had an IPO with her company and with all the characteristics necessary to qualify as an emerging growth company, she does IPO on December 8, she would qualify for all the benefits. But if she had done an IPO on December 7, she wouldn't.

So there's -- not sure how that really kind of plays out in terms of, you know, protection for investors.

But I think, you know, certainly a part of this kind of goes back to, you know, kind of the notion, to what extent does it make sense to have, you know, multiple markets? I think that might go to what Kathleen was saying as well.

I certainly -- I certainly think that what relief that we have provided for some companies probably could be extended to others. And I also probably made clear that

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I think it makes some sense in terms of coming up with kind of another market to operate kind of alongside the markets we currently have in place. Definitely might make things easier.

Just conceptually or intuitively, I feel if we had a market and it was geared only to accredited investors and so all the disclosure was simplified accordingly, but nonetheless, who was that you -- you were going to have access to in fact every accredited investor in the world, that you could probably build something. But that's just -- I mean, it seems to me those are -- those are things that we're going to need to explore.

Yes.

MR. BORER: It's hard to make a recommendation that they should study the fact that we're all really worried about the IPO market being dead and being unfair out there for small companies.

One thing I think that makes a lot of sense to some of the stuff that has been talked about today seems to be recommendation that the SEC studies this or it actually looks at regulation can do this as opposed to legislation.

But I think making all the companies who are already public subject to similar reporting requirements

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that were created in the JOBS Act for that first five years seems like a no-brainer. It absolutely seems like a no-brainer. Why somebody didn't say, hey, why are we putting shackles on these people already because they were dumb enough to already get public and letting these others, you know, run without that problem, that seems like a very easy recommendation. And it's not just because I'm sitting next to Chris.

The other thing with respect to -- David is gone now -- Wall Street and the indicting statistic up there today was how many book running managers were there ten years ago versus how many there are today? And it doesn't have anything to do with the fact there's high speed trading taking up the gap. They don't bring companies, you know, public. Morningstar is not bringing companies public. That's just a misunderstanding in the market.

If there's anything that can be done to create more H&Qs, Alex Browns, Behrman Sells, Sutros, Adbest, Tucker Anthonys, you know, all these guys, we should try to do it, or else the government is going to have to step in with something like Community Reinvestment Act and say to these big brokerage firms, unless you guys do these 20 small IPOs a year, we're not going to let you do business with the treasury, okay, in the market. And

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I don't think that would make sense. It didn't work with big banks, it's not going to work with brokerage.

Pick up something specific. If it's tick size, I don't see any downside to it. It may be politically unpopular because people would say, well, if mom and pop investor might by paying another -- you know, a higher commission than they did through -- they are right now through Scottrade. Scottrade at 5.95 isn't giving them any service. It's a wonderful execution platform, but there's no service. And it's dried up the small end of the market, not only for the IPOs, because those firms don't exist anymore to bring them, but also the execution and follow-on.

It was -- this morning I think it was David said, he's been on desks, he's run desks. I'm not going to put up $10 million to take a block of stock because I can't pay 25 cents. I can make 1 cent on the upside and $2 on the downside as far as per share. It just won't happen.

And you can regulate all you want, but if the regulation makes it so that the people you're regulating have no incentive to take the risk unless you force them to take that risk through some mandate, they won't do it, we go home. I think that's what's taking place.

So either investigating or actually

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implementing something, even if it's on a test or trial basis with this tick size, voluntary or algorithmic or otherwise, it's -- you know, it's a little expression, light one candle, you know, as opposed to cursing the darkness. Because if we just say, let's encourage more small brokerage firms to get in business and see if they do IPOs, we're going to be too old to see the results. It won't happen.

So those are two specific things I would suggest we take a look at.

MR. GRAHAM: Agreed, agreed.

MS. JACOBS: Feel the same?

MS. SMITH: I totally agree with everything John said. I think he's spot on.

MR. GRAHAM: You got to give us more than that, Karen.

MS. SMITH: Well, I --

MS. JACOBS: We'll take the I agree.

MS. SMITH: No, I appreciate it because, I mean, I've been struggling today with what is our mandate, like what this committee's mandate, now given the changes that happened since we first met around this time last year because the JOBS Act, all the things that have transpired since then. So I appreciate John articulating it in the way he did. I think those are

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two very concrete recommendations that we could actually make.

MS. GREENE: I'll jump in real quick. I know we're out of time. But I absolutely agree with what he said on both counts. The exemptions and things that were done with the JOBS Act doesn't help me, doesn't help Chris, doesn't help existing companies because we were dumb enough to go public, whatever.

So but even more so than saying, okay, take all those exemptions and apply them, let every company take them. Well, but I want them longer than five years if I can't get my market cap or my revenue or my assets or whatever up over some amount.

So as Chris said at the beginning where that 75 million market cap, which I really appreciate right now, because we're under that, but if we crowd -- if we get close to that number, my incentive to stay under that market cap is going to be really high, which works totally against investors, because I don't want to do 404(b). I don't want to do all those things.

So, as Chris said, where 75 million dollar market cap came from as far as exemptions or small reporting companies, I think that needs to be -- certainly needs to be increased. Whoever said the market cap $787 million is 94 percent of the total

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public company value, and so everybody under -- you know how far away a $787 million market cap is for us? It will never happen in the lifetime of me and the next ten generations, I suspect. So, but that's only 6 percent of the total public company value. And we're -- you know, we help the little companies under 75 million.

So I will jump out there and say I like what John said, but I would make that -- those small company exemptions -- set the market cap so if I still don't hit whatever the market cap is in five years, I don't fall off that exemption thing and go, oh, now you're there. So -- based on what Chris said.

Some of the things that Charlie said, and these are just -- I wrote them down so I wouldn't ramble too much. So there is no -- as Charlie said, the perception of being public, there's no payoff for that for a small company. Whether that's reality or not, that's the perception. And I don't hear any small public companies talking about how great it is to be public, because there is no -- there's no payoff.

Making the IPO process -- and I don't know which one of you guys said it -- making it more attractive doesn't solve the lack of post IPO support for small companies. So you go out and, you know, you do this great IPO, but if you're not -- if you're not

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the billion dollars or whatever, there's no money in it for the guys that actually used to provide that support -- that support in terms of research and investment banks and whatever.

I can't tell you how many investment banks I talked to. I have no deal for you. Well, they're not going to make -- I mean, we trade 5,000 shares a day. They're not going to go for that. I mean, there's nothing -- there's nothing that our company's doing that would incentivize anybody to put any support in, make the phone calls to the brokers, whoever said all that. There's no money there.

So until there's money there, and maybe that's tick size, until there's some financial incentive for those guys that used to support public companies, small public companies -- until there's some financial incentive, I don't think -- I don't think anything is ever going to be solved. Companies are not going to go public because they can't get the aftermarket support. Nobody in -- out of the goodness of their heart is going to spend a bunch of time trying to support very small companies, because we're all in everything we do to make money.

So I think -- I think tick size is the most concrete suggestion I've heard. And I don't understand it exactly either. I don't know -- if you came to me

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and said, what do you think your tick size is? I don't know. But why not try it? I mean, it can't get any worse, right? I mean, for us it can't get any worse. For Chris, it probably can’t get worse. So why not try it. It's a concrete suggestion. Let's -- why not throw it out there.

Investor interest, it is about increasing shareholder value, which is increasing stock price. That is the result of earnings and growth. Cost to be public, million dollars, whatever. You take that out of your earnings, the pressure on earnings to continue to grow in order to increase your shareholder value, in order to keep investors interested, it's very circular. And the more money you spend on stuff, cost to being public, whatever, reduces earnings. If you're not growing earnings, then the investors aren't interested in you. Again, they're in it to make money, they're not in it because they're feeling generous today.

SarbOx, somebody said, had a very small impact. I adamantly disagree with that. But that may be perception now more than anything. SarbOx, the idea why public companies don't -- or why private companies don't want to go public. SarbOx is a huge issue. And whether that's reality or not, the perception is it's a huge issue. I don't want to deal

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with the SarbOx stuff, so --

And then even if the original reason for wanting to go public is to raise capital, don't we all want to get -- and I throw this out. I'm tired and maybe this doesn't make sense. But don't we all want to get to where we don't need to raise money? I mean, don't we want to grow our companies to where they're organically growing to support or growing enough that we can support our growth internally with organic cash flow and all that, as opposed to having to go back out to the market to garner more -- to raise more capital?

So capital formation may be -- or capital raising may be a viable reason to go public to start with. But I know, in my mind, I would eventually want to outgrow that anyway. Once you outgrow that and you don't need to raise money, as Richard said, we have so much cash on the balance sheet, then you have no deal for anybody to do anything for you, so, you know, again it's circular. There's no support.

MS. JACOBS: So then why go public?

MS. GREENE: Yeah. I mean --

MS. JACOBS: You can’t get out, you’re going to get sued --

MS. GREENE: Or you're going to leverage your company so bad to get out that -- yeah. So recommendation is raise the $75 million market cap on

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small reporting companies up to -- I don't know, I mean, 787 million sounds like a great number, but, you know, I'll take 500 million or whatever. I think that's a great recommendation.

Tick size. The only concrete thing, I mean, that I've really heard that might help the aftermarket support for those people that can actually do something with your stock, the market makers and the traders and all that, why not recommend that and see what the SEC comes up with?

MS. JACOBS: Any other -- any discussion around the 787 million market cap?

DR. RITTER: I've got a catchy acronym. We call it the "BOEING" amendment.

MR. DENNIS: The problem with -- if you go up to 787 million, and I'm trying to remember the statistics we looked back four, five years ago, Gerry. But the 75 million, I believe, came from, it was 1 percent of the market cap, is where that -- I thought that's where we kinda came up with that recommendation. Because it was 25 million at one point. The 787 million, although it's 6 percent of the market cap, it's something like 80 percent of the number of public companies.

So if you exempt 80 percent of the public

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companies out there from Sarbanes-Oxley, and you've kind of done an end run around Congress and the law, and I think you get -- I think it's easy to say. I think it's hard to go down and say, Congress adopted a law that said public companies have to do this and the SEC is going to exempt 80 percent of the public companies out there.

MS. GREENE: Well, I think lower the number, then. Go to, I don't know, go to 75 million.

MR. LEZA: Go to 250 million, like I said before.

MR. DENNIS: I'm just saying it's harder than just that. But --
MS. JACOBS: Right. But the law -- but Congress itself has exempted companies up to a billion in revenue, which I don't consider emerging, but that's how they've identified them.
MR. DENNIS: First five years of their existence, right.
MS. JACOBS: That's right.
MR. GRAHAM: Yeah.
MS. JACOBS: Yeah.
MR. GRAHAM: So you've raised a very good point. And I think that one of the reasons why we frequently have issues is that people kinda don't normally -- they're really unable to foresee the

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unforeseen consequences. And I think that's one of the things that I want to make sure that we do as a committee, make recommendations, perhaps raise certain issues that were raised.
We are past time to -- wrap things up. Has everyone had a chance to comment?
(No audible response.)
MR. GRAHAM: What I would like to -- I've heard -- again, there are a number of things that we talked about. And I think that there is -- the seeds have been planted, I think, for a number of recommendations. Certainly there are two or three things that are relatively concrete on the table. And that is the tick size. One has to do with expanding the -- expanding the relief that was provided under the JOBS Act for a broader group of small public companies, which just happen to have gone public before December 8 and -- am I missing one?
MR. DENNIS: Conflict minerals. Let's put conflict minerals. I mean, I'd put it on just because I think conflict --
MS. JACOBS: I don't think we have a thing to lose.
MR. DENNIS: Well, I think Congress doesn't read these reports.

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MS. JACOBS: Yes, no.
MR. GRAHAM: We'll make recommendations to the SEC, so I'm not sure.
MR. DENNIS: I don't know how we word it, but --
MR. GRAHAM: I'm not sure if our mandate says to do that.
MS. JACOBS: But I think we can go on record as recommending --
(Talking simultaneously.)
MR. GRAHAM: (Inaudible.)
MS. JACOBS: -- an exemption.

No, that's an action. It's not going against the law, right? Can't we recommend -- can't we say something about an exemption?

MR. LEZA: As long as you define it as a recommendation, you can say whatever you want.

MS. JACOBS: Exactly.

And I have one follow-on for Leroy.

Leroy, there are several studies out there, one in particular is a high state and the couple of others that have defined small reporting companies, and they range from 250 million to 700 million, and maybe what we could do is sort of hold to find out a propensity of what that market cap should be.

MR. DENNIS: Yeah, you can --

MS. JACOBS: You understand?

MR. DENNIS: Yeah. There's all kinds of statistics out there, so what number of companies you're going to impact.

MR. GRAHAM: What I was about to say was we might do kind of thinking about maybe doing what we did last year with respect to what is that -- what is the recommendation that we said we approved telephonically?

MS. ZEPRALKA: That was Reg D.

MR. GRAHAM: Was that Reg D? I'm thinking about when we can have our next meeting. And obviously next month is October, which means into the holidays. Not going to do anything next month, November, December. But it might make some sense to formulate some recommendations around these few items, then get them out to the group.

MS. JACOBS: Oh, well, there's some very practical reasons. Because those of us that are public in January of 2013, several of these exemptions, Say-on-Pay, frequency of Say-on-Pay, we have no reprieves, so we are under a deadline as public companies.

MR. GRAHAM: So we're going to make a recommendation. That's not going to be changed by that.

MS. JACOBS: No, but really nice to have a place card holder out there. Correct? We're up against deadlines January 2013, those of you that aren't public.

MR. GRAHAM: Okay. Ladies and gentlemen, thank you very much.

MS. JACOBS: Thank you.

(Whereupon, at 4:17 p.m., the meeting was concluded.)

* * * * *

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PROOFREADER'S CERTIFICATE

In The Matter of: MEETING OF SEC ADVISORY COMMITTEE ON SMALL AND EMERGING COMPANIES
File Number: OS-265-27
Date: Friday, September 7, 2012
Location: San Francisco, CA

This is to certify that I, Donna S. Raya, (the undersigned), do hereby swear and affirm that the attached proceedings before the U.S. Securities and Exchange Commission were held according to the record and that this is the original, complete, true and accurate transcript that has been compared to the reporting or recording accomplished at the hearing.

_______________________ _______________________
(Proofreader's Name) (Date)

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CITY OF COUNTY OF SAN FRANCISCO)

I, SUZANNE I. ANDRADE, CSR NO. 10682, a Certified Shorthand Reporter of the State of California, do hereby certify:

That the foregoing proceedings were taken before me at the time and place herein set forth; that a verbatim record of the proceedings was made by me using machine shorthand which was thereafter transcribed under my direction.

I further certify that I am not interested in the outcome of said action nor connected with, nor related to, any of the parties in said action.

IN WITNESS WHEREOF, I have hereunto set my hand and affixed my signature this 13th day of September, 2012.

SUZANNE I. ANDRADE, CSR NO. 10682
STATE OF CALIFORNIA

0296

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In the Matter of: MEETING OF SEC ADVISORY COMMITTEE ON SMALL AND EMERGING COMPANIES
File Number: OS-265-27
Date: Friday, September 7, 2012
Location: San Francisco, CA

This is a letter to inform you that we do not release our tapes and notes. I do maintain them for a period of one (1) year.

Sincerely,