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GOVERNMENT-BUSINESS FORUM ON

SMALL BUSINESS CAPITAL FORMATION

RECORD OF PROCEEDINGS

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C O N T E N T S

MODERATORS:

Gerald J. Laporte, Chief, Office of Small Business Policy SEC Division of Corporation Finance

Chad Moutray, Ph.D., Chief Economist and Director of Economic Research, Office of Advocacy, U.S. Small Business Administration

PANELISTS:

Todd Flemming, President and Chief Executive Officer, Infrasafe, Orlando, Florida and Member of Executive Advisory Board, Small Business and Entrepreneurship Council, Oakton, Virginia

Eric R. Zarnikow, Associate Administrator, Office of Capital Access, U.S. Small Business Administration, Washington, D.C.

C O N T E N T S (Continued)

C O N T E N T S (Continued)

PROCEEDINGS

[9:09 a.m.]

CALL TO ORDER

MR. LAPORTE: We'll get started. We'd like to welcome all those who are physically present here at the SEC Auditorium in Washington as well as all of those who are in cyber space listening to the Webcast of these proceedings.

Last year, we had somewhere over 900 hits on the Webcast of these proceedings. We hope to equal that number this year.

My name is Gerry Laporte. I'm Chief of the Office of Small Business Policy in the SEC's Division of Corporation Finance.

I am here to call to order the 28th Annual SEC Government-Business Forum on Small Business Capital Formation.

This event is being conducted under the mandate of Section 503 of the Omnibus Small Business Capital Formation Act of 1980.

I am going to give the caveat on behalf of all the SEC speakers today that the views that they express today are their own views and don't necessarily represent the views of the Commission or other SEC personnel.

MR. LAPORTE: I'll start off the program by introducing the Director of the Division of Corporation

Finance in which the Office of Small Business Policy is located, Meredith Cross, who herself will be introduced at greater length when she serves as a moderator for the 11:15 panel discussion.

Meredith?

INTRODUCTION AND OPENING REMARKS BY CHAIRMAN SCHAPIRO

MS. CROSS: Good morning. Thank you, Gerry. Welcome, everyone. This is a terrific event and a topic that's very important to the Division of Corporation Finance and to the Commission as a whole.

We very much appreciate you all coming here today and sharing your experiences and insights with the Commission and with the public.

I will be moderating a panel later this morning on the topic of the "accredited investor" definition, but first I have the honor of introducing the Chairman of the SEC, Mary Schapiro, to open the forum.

Chairman Schapiro re-joined the SEC in January 2009 having previously served as a Commissioner in the late 1980s and early 1990s.

She was formerly the Chairman of the Commodities Futures Trading Commission and prior to joining us here, she was the CEO of FINRA, the Financial Industry Regulatory Authority, which is the largest non-governmental regulator for securities firms doing business with the U.S. public.

Chairman Schapiro has been leading the Commission in a time of great change and renewed focus on our mission of protecting investors. Under her guidance, we are all hard at work on the agenda for the Commission designed to restore investor confidence in our markets and provide for access to capital for the business community.

It is now my pleasure to turn the podium over to Chairman Schapiro.

(Applause.)

CHAIRMAN SCHAPIRO: Thank you very much, Meredith. Good morning, everyone. Let me add my welcome to the others. It's wonderful to have you all at the SEC today. We appreciate that so many of you are participating in today's meeting, and I hope that you will learn as much as I know we will learn during the course of the day.

As you all know, the SEC's mission is three pronged, to protect investors, to maintain fair and orderly markets and efficient markets, and to facilitate capital formation.

Today we are focusing primarily on the third, facilitating capital formation. But, I think it's important that we don't think of these three prongs as distinct or separate goals. They are in fact intertwined and interdependent.

We cannot have fair and efficient markets without the ability of companies to effectively raise capital, and companies cannot raise capital unless investors believe that the markets are fair and orderly.

Without access to capital, business slows. Without investor confidence, capital disappears.

That is something the business community knows all too well and it is something that I as the daughter of a small business operator who recently retired at the age of 88 understand as well.

Today's forum specifically addresses small business capital formation. This is particularly appropriate because as President Obama recently said, small businesses fuel our prosperity and have to be at the forefront of any recovery.

The first panel of today's forum will take a closer look at the capital formation needs of small businesses in today's economic environment. During this discussion, you might consider the project we are currently undertaking to reassess all the things we ask companies to disclose in their SEC filings.

Currently, we require among many other things, disclosures about a company's business, its properties, locations of all its operations, and the business experience and education of each director and officer.

But, is all this necessary? If so, is there a better way to impart that information to investors?

This effort will not only identify what more should be disclosed but also what no longer needs to be disclosed, as we firmly believe that more isn't always better.

So We are very much interested in your views and having you help inform us on this major review of disclosure.

The focus of the second panel will relate to private securities markets, markets that small businesses often turn to for their capital needs, and this is a market whose efficiency is included within our mission.

During the second panel, participants will discuss, as Meredith said, the SEC's definition of the term "accredited investor," which figures prominently in our regulatory scheme for the private securities markets.

It clearly is very important to get this definition right so that investors are protected and companies continue to have adequate access to capital.

We will be interested in what the panelists have to say and continuing the conversation to make sure our private market regulatory scheme is consistent with the needs of today's investors and markets.

Breakout groups this afternoon will develop recommendations in four areas, private securities offerings, securities regulation of smaller public companies, taxation, and private placement and M&A brokers.

We look forward to receiving recommendations in each of these areas.

Before closing, I'd like to acknowledge the presence here today of a number of state regulators. We recognize the important role that state securities regulators traditionally have played in protecting investors in local and smaller companies, and look forward to continuing to work with them closely in this area.

I'd also like to acknowledge the many congressional and administration offices that are represented here today as well. I think this further indicates that the issues affecting the small business community are critical to a broad range of public policy makers and we are all interested in hearing what you have to say.

Again, thank you for your support of the SEC, your energy, and most importantly, your participation today. We look forward to benefitting from your views and expertise.

Thank you.

(Applause.)

MR. LAPORTE: Thank you, Chairman Schapiro, for those very inspiring remarks.

Before we start the panel discussion, I'd like to recognize the staff of the Office of Small Business Policy, that I head, who are responsible for putting together this program.

Tony Barone. Tony does most of the organizational work for this forum. We all owe him a debt of gratitude for all the details he's had to attend to in staging this event.

We have Corey Jennings. Corey is standing over to Tony's left. Corey is the person we rely on to translate our needs to the computer people, the facilities people, the sound and stage technicians. Sometimes it's not easy to translate our needs to these people and Corey does a great job.

Johanna Losert is also on our staff. Kevin O'Neill. Sean Donahue is down in the front. Netta Williams, I think she might be out at the registration table, so she's not able to be recognized. Stephen Fowler. I don't see him. He's our academic intern.

Last but not least, Mauri Osheroff. Mauri is not actually a member of the staff of the Office of Small Business Policy but she oversees the work of our office as Associate Director of the Division of Corporation Finance.

We have distributed program booklets to those here in the SEC Auditorium in Washington so that you can follow these proceedings better. The program booklets contain an agenda of the proceedings and the biographies of all the panelists.

Those biographies contain more information than we will have time to go over when we introduce the panelists during these discussions. If you want to learn more about these panelists and the other panelists for the second panel, you can look at the biographies. They are all very impressive biographies.

For those of you listening over the Web, the program booklet is available through a link on the Web page that allowed you to tune into this Webcast, so you can also follow the proceedings by looking at the program booklet.

We at the SEC learn a lot from these discussions and these forums, the insights and experience that both the panelists and the participants in the breakout groups this afternoon share with us.

We are looking forward to receiving the recommendations that come out of today's proceedings. As I said, the recommendations will be developed in breakout groups this afternoon in conference rooms located throughout the SEC Headquarters Building.

We are asking people after this morning's proceedings to come back at 2:00 this afternoon. This Auditorium will be where the participants will be escorted to the conference rooms throughout the building.

Those of you who aren't at SEC Headquarters but have registered to participate in the breakout groups by conference telephone call, you may call the breakout group telephone numbers and access codes that were e-mailed to you yesterday or the day before.

You can submit questions for discussion by the panelists today. We have some manila cards in the back. If you want to give your cards to one of the staff members who will be floating around here, they will bring it up here and we will try to get the panelists to answer as many questions as possible.

We don't know how many questions the panelists will be able to answer. This isn't primarily a question and answer -- neither panels are primarily a question and answer session, but we have made this facility open to people.

PANEL DISCUSSION:

THE STATE OF SMALL BUSINESS CAPITAL FORMATION

MR. LAPORTE: With that, I'm going to go ahead and start the panel discussion by first introducing my co-moderator, Dr. Chad Moutray. Chad is Chief Economist and Director of Economic Research at the Office of Advocacy of the U.S. Small Business Administration.

He is the President of the National Economists Club and serves on the Board of the National Association of Business Economics.

Before Chad joined the Office of Advocacy in 2002, he was the Dean of the School of Business Administration at Robert Morris College in Chicago from 1998 to 2002, where he taught economics and finance courses.

Chad?

MR. MOUTRAY: Good morning. Thank you, Chairman

Schapiro and Gerry and everyone else here at the SEC -- I almost said SBA -- for organizing this forum and for your continued focus on small business issues.

So far, in this great recession, which we hope is now over, the U.S. has lost 7.1 million jobs, and with every industry except for education and health services, they are suffering declines.

More than ever, we need to look for that next big thing that is going to propel our economy forward, and many people, of course, are looking towards entrepreneurship for that engine that is going to create new high paying jobs for all U.S. citizens.

I am pleased that so many policy makers from both political parties have focused on the role of small business entrepreneurship and the role that will play in terms of job creation.

Our own office has done research over the past couple of decades really that continues to show the role that small businesses play. For instance, using Bureau of Labor Statistics data, we know that 64 percent of all the net new jobs created between 1993 and 2008 were from firms with less than 500 employees.

Yet, small businesses are struggling right now, hampered by their ability to generate new employment, and one of the reasons that is often cited, of course, is the lack of credit, which of course is what brings us here today.

Yesterday, the SBA and Treasury hosted a one day conference dealing with this very issue, and it will be interesting this morning to hear from Eric Zarnikow, Associate Administrator and my colleague at SBA, to have some comments on what actually came from that.

More importantly, the SBA has had some pretty dramatic increases in 7(a) and 504 lending's since March with the stimulus passage. Outside of SBA lending, there continues to remain many, many challenges that we want to continue to focus on here this morning.

With that, without further delay, let's go ahead and start the panel where we can learn about the current state of small business capital formation in the United States.

For each speaker, I will give you a quick bio and then we will turn it over. We are going to start this morning with Todd Flemming. Todd is the President and CEO of Infrasafe, a firm that provides physical and information security services. Before co-founding Infrasafe, he served as President and CEO of Advantor Corporation in Orlando. Todd also has significant experience as a venture capitalist and is a member of the Executive Advisory Board of the Small Business and Entrepreneurship Council, and of course, Karen Kerrigan was my co-moderator last year. It will be interesting to hear from you, Todd.

MR. FLEMMING: First of all, I'd like to thank Chairman Schapiro and the SEC for having us here. This is a very important topic.

I'm a small business owner and entrepreneur. For a lot of us, we are going through some very tough times and some of us bitter times.

Infrasafe, first of all, is my company. We have a small Subchapter S corporation called Advantor, which primarily does electronic security work for the Federal Government, and then last year we formed an LLC called Veristream, which will provide security products and services for the private sector.

I also represent the SBE Council. Karen Kerrigan has been a tireless advocate for promoting entrepreneurship and policies that support small business growth.

You can find a little bit more about the SBE Council at Sbecouncil.org and I'd encourage you to learn more about the organization.

First of all, there has been a lot of recent press about job creation and the real key to getting the economy going is job creation. There is clearly a correlation between small business capital formation and job creation.

Kauffman recently released a study that indicated pretty clearly from U.S. Census data that two-thirds of recent job creation came from new businesses. In other words, start up businesses that were started within five years.

Clearly, having access to capital to start new businesses is extremely important to creating jobs and employment, and if that is one of the keys of getting our economy going, it's important that we also focus on small business capital formation.

One of the things I guess you have to ask is what do you need capital for right now? Growth capital or survival capital. For a lot of companies, the capital they need is for survival as opposed to growth.

For those entrepreneurs and small business owners in the audience, it's a great time to start a business. The last two businesses that I've started, I started in a recession, in the early 1990s, and after 2001, and you have a lot of good opportunities. You have access to really great employees. Rents are cheaper if you need office space. It is really a wonderful time to start a business. I think that is something important.

I am going to touch on some of the ways that small businesses are financed just briefly, and most of the panelists will probably drill a lot deeper in some of these areas, so I'm just going to sort of skim across them. Some of them are probably obvious to folks and some of them may not be.

First of all, 41 percent of businesses said their current focus is maintaining current sources of revenue as opposed to 26 percent who are focused on growing their business. This is the lowest number the American Express Monitor which monitors and surveys small businesses has seen.

It is sort of a hunker down mindset, let's survive and stay in business as opposed to let's invest and grow our business. That says something about it.

The entrepreneur sector is extremely resilient. We come up with all kinds of great ways to adapt to various situations, including the unavailability of capital and credit.

That said, some of the recent forms of access are much less available to us and probably these are the most challenging times. I'd like to just sort of touch on some of the ways that small businesses are funded.

First, personal assets. When I started my first business, I had worked for a Fortune 500 company. I put some money aside. Then I used that money to start a business. Unfortunately, a lot of people's personal assets have been eroded quite a bit, so they may have less personal assets available to them to start a business than they once had.

The other form, I've heard numerous time from some of my colleagues who started their businesses using their credit cards, and for anyone, credit card and credit availability through credit cards is much less available also. A lot of credit cards have been canceled, the limit reduced. That type of funding is less and less available to a small business to start their business.

The other one that you hear of quite frequently, and when I started my businesses, is home equity. I don't have to tell anybody home equity has been eroded substantially in the last couple of years, and then the access to home equity loans which you might use to start a new business are also not available, whereas when I started my businesses in the early 1990s and early 2000s, those things were available to folks, as well as some of the others.

The other place is friends and family. A lot of folks are cautious and aren't as willing to invest in small businesses.

Private credit investors or angel investors are also another source, usually for someone who has proven their business plan. I make some of those investments myself.

I'll tell you if you have made small private investments in the last three or four years, some of your companies are probably in trouble or don't exist. The ones that do exist, they will promise you probably -- you will be asked for more money to fund those businesses, so there is less new money available, angel money, to go in, and there is also a lower tolerance of risk for those investors.

Probably the biggest source for small businesses of capital formation is simply reinvestment of their existing cash flow. Reduced demand has resulted in substantially lower cash flow for reinvestment.

Sixty percent of entrepreneurs report cash flow issues are slightly up from the previous Fall, which was 55 percent, and in the Spring, 57 percent.

You have a lot of small businesses facing cash flow issues. They don't have positive cash flow. They're making the decision between do I retain this employee or let that employee go as opposed to reinvesting their capital in investment opportunities.

Another interesting area is private equity investment, including your traditional venture capital funding. While it was fairly rare to begin with, from what we found in the market right now with an offering to private equity funds, a minority offering, the interesting thing is they are in an interesting position whereas there is a lot of capital available with these funds and not a lot of great cash flow positive or safe companies to put those monies.

They have some pressure from their limited partners to put that money to work. If I'm a limited partner in a private equity firm and they're sitting on a mountain of cash, I'd probably be asking for that money back.

They are out in the market and active. I just don't think right now they have enough great traditional type investment opportunities.

That leads us to banks. One of the things you hear a lot of is the reason small businesses aren't growing is they don't have access to credit. Credit lending standards have been tightened but the real issue is there is less demand.

I was often told the worse time to go to a bank is when you're desperate for the money because I can assure you that you're not going to get it even in the best of times, and the best time to go to a bank and ask for money is when you really don't need it.

From that standpoint, there is substantially less demand, in other words, small businesses going to banks for lending, and you also have a situation -- I have a number of associates who negotiated a credit facility in different times. They had higher asset values, they had better cash flow, and then two things happened.

One is either the business fell off, they had not as promising cash flow, they had lower asset values in some cases, and then the banks came in and really tightened the screws, so to speak. In other words, the terms on renewal were substantially different than when they may have undertaken the original facility a couple of years ago. That has made it very tough on a lot of businesses who have had to renegotiate loans.

Tighter lending standards is part of it. Thirty-six percent of banks reported tightening credit standards for small firms in the last three months and only two percent reported using standards.

Non-bank lenders is another form, with CIT in trouble and other issues. They have sort of the same drivers as banks.

SBA, until recently, the secondary market for SBA loans wasn't really there. That has changed quite a bit. I was talking to one of the other panelists. The Small Business Association lending is up pretty substantially and that's great, especially considering what has happened with bank financing.

Just one other area I'd like to touch on, if it's not hard enough to gain access to capital as a small business, we have some substantial head winds that look like they will be on the forefront in 2011. It's almost certain that we will have an increase in capital gains taxes from 15 to 20 percent. We already have amongst the highest capital gains taxes in the world.

I was told by a Democrat Congressman, if you want more of something, you subsidize it. If you want less of something, you tax it. We're getting ready to increase our taxes on capital by 25 percent which in my mind as a small business owner/investor makes no sense.

In addition to that, there's a number of high performing Subchapter S and pass through corporations which will be dramatically impacted by an increase in the personal income tax rate to 39.6 percent, monies that ordinarily would have been reinvested in the business will be taxed. Again, it's a pretty substantial corporate tax for those pass through entities.

I think the last thing is even though we have some very tough situations with respect to deficits, we really need to focus on taxing the right things, and taxes on capital will erode our competitiveness. We are now competing for capital on a global stage.

The Chinese capital gains tax rate is zero, as are a number of other emerging economies.

That's about all I have. If anybody has any questions afterwards, we can go from there.

MR. LAPORTE: Before we introduce the next panelist, I'd like to acknowledge the presence of SEC Commissioner Troy Paredes who walked in at the beginning of Todd's presentation. Commissioner Paredes will be providing remarks at 11:00 and Meredith is going to introduce him at greater length at that time.

Welcome, Commissioner Paredes.

MR. MOUTRAY: Thank you. Thank you, Todd. Now it is time to turn it over to Eric Zarnikow, again, my colleague at the Small Business Administration. He is the Associate Administrator for the Office of Capital Access.

Eric took that position after serving as Senior Vice President and Chief Risk Officer and Treasurer at ServiceMaster, where he played a major role in the sale of the company to a private equity firm.

Eric also served as an independent Board member and Audit Committee Chairman of Caraustar Industries, a publicly traded company with approximately $1 billion in annual revenues, and I'm looking forward to hearing about yesterday's conference.

Eric?

MR. ZARNIKOW: Thank you. I'd also like to thank Chairman Schapiro and Gerry for having us here at this forum today.

Small business finance is certainly a very timely subject. I am really going to spend a few minutes talking about three areas. First is the importance of small business finance. I think you are going to hear some common themes there.

Secondly, what has been happening in the overall market for small business finance and access to credit, and also talk about SBA's role in providing access to capital for small businesses and also the impact we have seen coming out of the Recovery Act on SBA lending programs.

As Chad mentioned, yesterday, the SBA and Treasury hosted basically a full day forum on small business financing. This was something that the President asked us to do. He is very interested in the state of small business and small business financing.

At the forum, we really heard from a broad range of people, small business owners, lenders. We heard from financial institutions, members of Congress, regulators, and a number of advocates who brought a broad range of perspectives on what is going on with small business finance and what are things that might be needed from a policy standpoint and where we might be able to help the state of small business finance.

What are some of the challenges in the current environment that small businesses are facing in financing their businesses and as we look to recovery, what are those things that are going to be important to help lead us out of recovery.

We are going to be putting together a conference report from that forum. It will be posted publicly on both the SBA and the Treasury Websites. We are also going to be delivering that report to the President.

The first question is why do we care about small business finance, and you really heard this from Chad, and if you really summarized it up in one word, that word would be "jobs."

Firms with fewer than 500 employees represent about 99.7 percent of all employer firms. They employ just over half of all private sector employees. They are very important drivers of jobs.

In the recovery period following the most recent recession in 2001, small businesses drove positive employment gains really one or two quarters where we saw positive employment gains from larger businesses, and earlier this week, Federal Reserve Chairman Ben Bernanke was quoted as saying "The difficulties in obtaining credit could hinder the expansion of small and medium sized businesses and prevent the formation of new businesses because smaller businesses account for a significant portion of net employment gains during recoveries, limited credit could hinder job growth."

Small businesses are very important drivers of job growth and are very important in helping lead us out of the current recession.

What we have seen as far as the ability of credit to small businesses? Unfortunately, there is really not a lot of great data on small business lending that we get access to in real time.

We end up relying a lot on anecdotal evidence of things that we see going on in the marketplace. We get a lot of information from our own loan programs. One of the pieces of outside information we also look at at the SBA is the quarterly Federal Reserve Senior Loan Officer Opinion Survey that's done by the Federal Reserve.

Basically, what they do is they survey senior loan officers at different financial institutions. I should point out that banks provide about 90 percent of small business financing that's done from outside parties.

What we see is that the small business credit market really is still challenged. Standards continue to be tightened. They have yet to ease for conventional small business financing. There are a number of reasons for that.

When they do the survey, they see the banks are still concerned about risk, so 78 percent of the loan officer survey indicated they had reduced risk tolerance as part of the reason for tightening standards; 74 percent would say there's a less favorable economic environment, and I do think also that demand is an issue, that 45 percent reported there is reduced demand.

This next chart really gives you a visual of that senior loan officer opinion survey and what's been going on.

What we have seen -- let me describe this chart for you. The blue bars are where credit standards have basically remained unchanged. The green bars, the little ones at the top, are where credit standards have eased considerably or somewhat, and the red bars are where standards have been tightened somewhat or considerably as reported by the senior loan officers.

What you see here unfortunately is for the last eight quarters, we have seen double dipped red bars where the loan standards have continued to tighten. I should point out these are quarterly reports, so they are describing tightening of standards since the prior quarter. We continue to see tightening of standards.

I think also what was referenced earlier was access to non-conventional credit, if you will. There is a lot of use of credit cards in financing small businesses. In many cases, the finances of the owner of the small business and the finances of the small business itself may be very intertwined. They may use personal or business credit cards to start the business. They may use home equity lines of credit.

What we have seen on the credit card side is that area has been impacted as well. If you look at the upper left-hand box here, what you see is 34 percent of businesses reported they relied on credit cards for 25 percent or more of the financing they needed for their small business. Clearly, credit cards are an important source of financing.

However, there have been problems in that area over the last year, 41 percent of the small businesses reported that their credit line had been reduced and 79 percent of the small businesses have indicated that their terms for credit cards have worsened over the last five years.

Clearly, the draw back in credit cards has been an important draw back of financing for small businesses.

That is kind of what's going on in the overall market. I'm going to turn and spend a few minutes talking about SBA loan guarantee programs, what our programs are, what we have seen coming out of the Recovery Act.

I think it's important to note that as the SBA, we don't provide direct loans, other than in our disaster recovery area. We really rely on providing a partial Government guarantee of a loan that's made by one of our lending partners. That could be the bank. That could be a credit union, a non-depository lender.

Basically, we rely on that network or distribution channel to be able to help small businesses expand access to capital. We also have what we call a credit elsewhere test, where basically the institution has to represent they would not have made the loan on the same terms without the Government guarantee.

We are not trying to replace the private sector, but we are really trying to enhance access to capital for small businesses by providing a partial Government guarantee, and traditionally in our programs, we charge fees to both the borrower and to the bank that really subsidizes the cost of providing the loan guarantee.

What we saw earlier this year was in October of 2008, the credit markets really froze. That impacted the SBA secondary market that was referenced earlier, and we saw a significant decline in our loan volume.

I'm actually going to go to the slide that shows that. Basically, what you see on this slide, on the upper left-hand part, you see that our average monthly loan volume in our 7(a) and 504 programs -- which are our main small business lending programs, the 7(a) program provides working capital financing, equipment financing, and also real estate, and then the 504 program provides financing for fixed assets, commercial real estate, machinery and equipment -- in 2007, our monthly average loan volume was about $1.7 billion per month.

We saw the beginning of a decline in volume in 2008 where we averaged about $1.5 million per month, and then in October, you see a significant decline in our volume. Our volume was down about 50 percent, 40 to 50 percent by the time we got into the January time period. We work on fiscal years which end in September.

As part of the Recovery Act, we actually got nine

Recovery Act provisions, two of them which were focused on the 504 and 7(a) programs, and they provided fee relief where we basically eliminated up front fees for borrowers, and it also provided money to allow us to increase our guarantee up to 90 percent on our 7(a) loans.

Since the Recovery Act passed, we have seen a significant recovery in our volume. That is the chart moving up on the right. Our volume, if you look at the period immediately prior to the Recovery Act being passed and the weekly average volumes since then, volume has grown over seventy percent, so we have seen a substantial recovery in our volume.

Since September 2009, we actually guaranteed about $1.9 billion of loans, which was the highest level since August of 2007.

We have seen a very significant rebound in our lending volume. We think the Recovery Act has been a very important part of that rebound, and as part of the Recovery Act, we actually approved about $10.2 billion in Recovery Act loans that supports almost $14 billion in small business lending.

It was mentioned earlier that in the Fall, our secondary market for SBA loans froze. Where that is important is that about 40 to 50 percent of our lending partners take the portion that we guarantee, the Government guaranteed portion, and they sell that into a secondary market.

That is very important for a couple of reasons. It provides a source of liquidity for banks or non-depository lenders, and it also provides a source of capital because they sell that Government guaranteed portion at a premium.

Basically, with the credit crunch last Fall, the markets froze.

This chart actually shows what has happened in our secondary market. We really work closely with a couple of our partners to restore access to the secondary market.

Basically, we work closely with Treasury and the Federal Reserve and the Federal Reserve Bank of New York to get SBA loans included as part of the TALF program, where investors can use money that's borrowed from the Federal Reserve Bank of New York to buy SBA 7(a) and 504 loans, and then we also partnered with Treasury as part of their TARP program where Treasury committed up to $15 billion out of TARP to support SBA secondary markets.

If you look at the left-hand chart here, what you see is that in 2008, fiscal 2008, our monthly average volume of SBA guaranteed portions that were sold in the secondary market averaged about $328 million.

In October, we saw our volume plummet, and our monthly average volume was down 70 to 80 percent. With the operation of TALF beginning in the March/April time frame as well as TARP, partnering with Treasury, we have seen a recovery in our secondary markets where our weekly average loan volume is back to the levels it was prior to the credit crisis.

Importantly, if you look at the right-hand chart, the level of premium that our loans sell for in the secondary market is also an important driver of lending activity because the banks rely on that premium as a source of income and a source of capital, and basically the banks sell our loans to a broker-dealer who then creates pools that they sell to private sector investors.

The green line on the chart shows that back in fiscal 2007, about 40 to 50 percent of our loans sold at a premium of 106 or above. During the credit crisis, that dropped to virtually zero. You see that green line plummeting.

Since the announcements with TALF and TARP, we have seen a recovery in our premiums and they are actually back above levels that we saw in 2008, which has helped restore access to capital for small businesses by providing liquidity to banks and our other lending partners to be able to sell their loans into the secondary market.

In wrap up, I think small business is really important. It's an important source of economic activity.

It drives job creation. We have seen with SBA that our markets and the overall financial markets are improving, but overall, I would characterize them as still very fragile, so it is still difficult to access capital for small businesses, but we do see a recovery or improving environment.

Thanks.

MR. MOUTRAY: Thanks, Eric. Before we move on to our next panelist, I want to remind everyone, particularly those who are listening to us remotely, that you may submit questions to Smallbusiness@sec.gov. I actually already have a question which we will get to after all the panelists. Please send your questions this way.

Our next panelist actually just arrived from London. He's back from a day trip to give a speech over there. He's actually from D.C. He's a partner at the D.C. office of Jones Day, Andrew Sherman.

Jones Day, of course, is a law firm with over 2,400 attorneys worldwide. Mr. Sherman is a recognized authority on legal and strategic issues affecting small and growing companies.

He is an Adjunct Professor in the MBA program at the University of Maryland and also at Georgetown University where he taught courses on business growth, capital formation and entrepreneurship for over 22 years.

He is also a very well known author, publishing about 20 books, I believe, or something along those lines.

Welcome Andrew Sherman.

MR. SHERMAN: I'd like to thank the SEC and Gerry's team for what has been an amazing tradition, 28 years. You must have started when you were about 15 on this effort. I know we all look forward to it every year.

It's really our one opportunity to interact with the SEC and look at capital formation and public policy issues and hopefully offer a lot of suggestions for ways to continue to improve access and streamline the markets.

I've been asked to focus this morning on angel and venture capital. Before I do that, I just want to take one minute to build on some of Todd's and Eric's overviews of the state of the general capital markets, particularly as it applies to small and medium enterprises.

I agree with what Eric just said, things are getting better, the ice is melting a bit, but it's still pretty slow in the overall private equity markets.

We see more deals that are fragile, I think that was an excellent word, and with fragility comes the ability to derail. We are seeing transactions where term sheets are given but we're not getting to the closing.

Many of us who practice in this area, and I know I see a lot of colleagues in the room and I'm sure a lot more are watching on line -- our practices are like miniaturized economic indicators.

When transactional lawyers are busy, the economy typically is booming. When the bankruptcy guys down the hall are busy, that's not a good sign.

The second trend that I've seen is that the bar in the last 18 months in particular has become higher and narrower. If you're built like I am, that's a slightly higher bar to get through and to jump up higher, and that's the way many small companies feel lately in this weaker economy.

The third trend that I've seen is valuations are lower, deal terms are tougher. You have probably heard this analogy before. In many ways, the players in the capital markets have all taken two steps over to the right or to the left, depending on how you are measuring, so angels are acting more like venture capitalists and venture capitalists are acting more like private equity firms in terms of deal terms, types of documents that are used, covenants that you see, et cetera.

We have also seen a lot more follow on financing. What does that mean for a new company trying to raise capital? It means if you're not already in somebody's portfolio, your chances of raising capital have been reduced.

Many existing VC firms are doing triage or salvage, depending on how you want to define it, on the companies that are in their portfolios that show promise.

Some say that is throwing good money after bad. It really depends on an intimate knowledge of what these portfolio companies do and what they're capable of and whether they are worthy of capital.

That time, effort and capital jams up the opportunities for new investments.

The last trend that I've seen, to build on some of the things I've heard, is just a bit more of a closer to home mentality. Companies that are either in your expertise wheel house or down the street from you. I still think that people from Maryland are crossing the line to Virginia and vice versa. If it's not in your general geographic area, the chances are financing will not be provided.

Let's take a look at angels in venture capital. The first thing we need to do is kind of benchmark the compare and contrast between the two.

Last year, according to a study by the University of New Hampshire, angel investors did 51,000 deals, provided $25.6 billion in capital, and the most important thing for all of us to understand is those were almost exclusively in early stage enterprises.

Comparing and contrasting data from the National Venture Capital Association, the venture capital industry committed $28.2 billion to 38,084 transactions, mostly latter stage and some, as I noted earlier, were to existing portfolio companies.

If you look at those two pieces of data and you say venture capital gets a lot more limelight in the press and a lot more discussion even at conferences like this, but the angels are only a couple of billion dollars behind in terms of total capital committed, but most importantly, for job creation and economic stimulus is the fact they committed almost 46,000 more transactions.

Those might have been smaller amounts, but to understand the angel investor is to understand that it's not just quantitative, it's qualitative. Angels provide a lot more than a check. They provide a lot of mentoring, coaching and ongoing advice that you see sometimes at venture capital firms but not always.

I think if we're going to address better flow in the capital markets, we have to provide some more acknowledgement and recognition of what's going on in the angel capital markets.

Focusing in on angels for a few minutes, what are some of the trends that we have seen, some of the trends that all of us need to be more aware of.

The first one is up until a couple of years ago, the angel markets were horribly fragmented and disorganized. There was almost no way to collect good data on what was going on.

Kauffman funded some studies. John May and others were pioneers in creating the Angel Capital Association. John has been traveling around the world sharing angel investing best practices in a number of countries. I think he's off to China next week.

We finally have data that is more accurate. We have best practices and better documentation of deal terms.

Here is this very significant source of private equity capital in the private equity capital markets, but up until a few years ago, we had almost no data, no best practices, no formal organization of the industry.

Even Angel Capital Association Board members will tell you they have not yet captured all the angel investors.

You will see when we get to venture capital in a moment that a lot of angel investment, particularly in what the venture capitalists call the "fly over states," which is the bulk of the middle parts of the country, angel investment has been the trend for many, many years, and yet there's very little documentation of it.

Other trends in the angel market that are important. One, angels are flocking as groups a lot more often than they used to. Angel clubs, dinner clubs, regional investment clubs have become much more prominent, not only is there a chance to mitigate risk and to share economic terms, and of course, the wisdom of many is usually better than the wisdom of one, but again, we get better practices, more venture capital like presentation and decision making and term sheet like acting, which I think is good for the overall industry and good for entrepreneurs.

You have also seen an increase in regional and university based accelerators and incubators often having good relationships with angel clubs. I think at the University of Arizona, as an example, the Entrepreneurship Center is the office to the Desert Angels.

Where the angel clubs and the university entrepreneurship centers and incubators are all housed under one dynamic entrepreneurial roof, that has to be a good thing when it comes to facilitating small business capital formation.

Another trend that we've seen and I think was touched on by both Chad's comments as well as Todd's, is that angels have taken a significant net worth hit. Don't get me wrong. When that cashed out entrepreneur or successful person goes from a net worth of $20 million to $8 million, they are not missing any meals yet. I don't know that any of us are breaking out our huge violins and are worried about whether we will be able to get through the next day or week.

At an $8 million net worth, your appetite for angel style and early stage and risk investment is a lot less appetite than you had at a $20 or $30 million net worth.

That probably describes the portfolio hits of everybody in this room, probably with a few less zeroes on it, but your appetite for taking risk is going to be less when you take that type of net worth hit.

As the markets come back and the Dow and NASDAQ recover, there will be a trickle down effect in terms of appetite for angel investing.

A couple of last trends in angels, and I want to get to venture capital. You do see an increase in family business office investing. More and more families of significant net worth are hiring formal business office managers who are acting like investment or venture capital type managers.

I find this historically interesting because if you go back to the beginning of venture capital in this country, one of the first capital venture funds up in New York was Venrock, which of course was affiliated with the Rockefeller family. What's old is new and what is new is old, and we're coming back to America's wealthy families as a source for angel investment.

You are also seeing a lot more activity in terms of overseas angels and even sovereign funds investing in early stage enterprises. I think the latest number was $900 billion in debt to the Chinese Government, so why not have that same trend of solvent investing in overseas angels affecting our small business capital formation.

That was not meant to be sarcastic, although it does concern me from time to time.

Moving into the venture capital trends and some things that hopefully will trigger some questions.

At Jones Day, we recently held a mini-summit, asking the question is the venture capital model broken and can it be repaired and how should it be repaired. A lot of interesting things came out of that mini-summit.

Some of the major, major trends that came out of that summit were things like a complete and total lack of liquidity, which I think you're going to be spending a few minutes on in our next panel.

You look at venture capital funds often as vintages, like wine. Vintage funds that raised their capital and started deploying it in the early 2000s, whether that was before or just after that last recession that we had, these vintage funds by five to seven years need to have liquidity in their portfolios and that liquidity has come to an almost halt in terms of IPO markets, which I know you will be touching on, and even the M&A markets.

The M&A markets have not completely stopped. I'm glad to see there is some activity in small and mid-sized M&As. There are some great resources here, Mike from AMAA and others, who can give you more on that at a break.

The big point here is that valuations are still down, and the more they are down and the more they are looking like the same price that the venture capitalists paid for those companies or less, the worse it gets.

Exits are taking longer, there has not been as many home runs, very few companies that you can really point to that were venture backed that we can all talk about the way we did seven or eight years ago.

There is also some discussion about whether the way that venture capital funds are structured still makes sense. Do we need to take a new look at the structure of venture capital funds, a new look at how general partners are compensated, how they are staffed.

I know when you start getting into general partner compensation, everybody gets a little fidgety when the venture capital funds are in the room, but this is something that does need to be looked at. Do they need to have an even greater share of the back end, look at other types of investments that provide more liquidity.

There is also a concern about whether there is a mismatch right now between institutional venture capital and the entrepreneurs that they serve.

I remember back in the 1999/2000 era, if you wanted to start an Internet related business, you needed $1 million for the web designer and you needed another million for the infrastructure. These costs have been slashed significantly.

Many technology companies, they just don't need the type of capital that the average venture capitalist wants to provide in that $3 to $5 million range. It's a mismatch between the amount of capital and capital needed.

There is also a new kind of generation of entrepreneurs. I was at a conference over at G.W. recently. Donna Finn was the speaker. She has written a book studying the Gen Y entrepreneur. Many of these Gen Y entrepreneurs, they have zero interest in venture capital style investing and venture capital style controls or reporting, and they don't want to exit in three to five years.

If you're 22 years old and the thought of an exit at 27, when you're trying to build a lifetime legacy business, it's kind of scary to them.

I think that we need to look at this very high profile model that will continue, I think, to add value to small business capital formation, but we need to look at it more carefully.

One of the points that I think Todd touched on is there has been this melding over the last couple of years as the traditional private equity funds and hedge funds started moving away from their own investment models and their own investment algorithms, they began spilling into middle stage and later stage venture capital.

There is still a bit of blurred lines right now as to who is in what bucket as between hedge funds, private equity funds and venture capital funds.

I'll wrap up there. I just want to thank Gerry and his team again for what has been a wonderful tradition, and I look forward to interacting with some of you in the Q&A and at the breaks.

Thank you.

MR. LAPORTE: Thanks, Andrew, for that great presentation. Our next panelist is Barry Silbert. I'm pleased to be able to meet him. I've read a lot about him and his company.

Barry is the founder and CEO of SecondMarket, which is a marketplace for buying and selling illiquid assets, including private company stock, restricted securities of public companies and limited partnership interests.

Barry sort of fills the gap between Andrew, who talked about the private markets, and Anna, who is going to talk more about the public markets or small company securities. This is the in between market.

Barry was recently recognized by Fortune Magazine as "One to Watch" in the publication's annual 40 Under 40 issue.

He has been quoted in many leading publications, including the Wall Street Journal, the New York Times, The

Washington Post, Financial Times, USA Today, BusinessWeek and Forbes. He has been featured on CNBC, Bloomberg News, and Fox Business News.

We are glad he was able to take time out of his busy schedule to join us today at the SEC's annual forum on small business capital formation.

Barry?

MR. SILBERT: Good morning and thank you, Gerry, and your colleagues at the SEC for having me here this morning to speak.

First, by way of background, I want to provide a quick overview of SecondMarket. I founded the company in 2004 after being an investment banker for about five and a half years at Houlihan Lokey in New York.

The original idea was really simple. There's trillions of dollars of illiquid assets held by investors that lack a centralized and transparent marketplace.

Over the past five years, we have been able to successfully build what we believe to be the largest marketplace for illiquid assets.

Our market can be best described as a hybrid model, so we have both the online auction and trading platform, but it is supported by a large team of what we call market specialists.

Our staff totals nearly 150 employees out of offices in New York and Silicon Valley, among others.

To date, nearly 5,000 participants have become part of SecondMarket. They include global financial institutions, pension funds, hedge funds, private equity funds, and also high net worth investors. Collectively, these participants manage over $1 trillion in assets.

Our platform is free to access as a buyer and a seller and there is no subscription fees, no data fees. However, to comply with regulatory requirements, buyers are limited to only accredited investors, qualified purchasers or QIBs.

I should also mention that SecondMarket is a registered broker-dealer with FINRA.

There is currently about $25 billion in liquid assets for sale on SecondMarket. Gerry mentioned some of the assets, but they include unregistered securities in public companies, auction rate securities, bankruptcy claims, LP interests, mortgage backed securities, CDOs, whole loans, and most recently, we launched a market for private company stock.

We expect to complete about $2 billion in transactions this year, which is about a 200 percent growth year over year.

I want to now dive into a big problem that exists with respect to venture backed companies. There is a clear and unprecedented lack of liquidity for shareholders in these companies. This problem is evidenced by the fact that according to the NVCA, it's now taking over ten years for these companies to go public. Let me repeat that, ten years on average before going public. This is compared to on average five years just a few years ago. M&A exit as well has doubled to nearly eight years.

Why is it taking longer for these exciting venture backed companies to go public? For those who didn't see it, Grant Thornton put out an excellent paper early this year where they discussed the reasons why, as they put it, IPOs are in the ICU.

Interestingly, it's not a cyclical phenomenon, nor Sarbanes-Oxley exclusively, that has resulted in this length in time frame.

If I can draw your attention to the slide for a second, if you see on the top left, on average, there were about 520 IPOs per year, and you call it the "pre-bubble years." It was basically flat during the bubble years of 540, but over the past eight or nine years, we are now averaging 122 IPOs per year.

According to the paper that Grant Thornton put out, the requisite size for a company to go public nowadays has grown to the point that it is difficult if not impossible for small cap companies to go public through a traditional underwritten public offering.

If you look at the slide again on the color codes, I believe it's orange, that is deal sizes above $50 million, and the blue are deal sizes below $50 million. You can see the obvious trends over the most recent time frame.

As IPOs have declined, so has the total number of listed companies on U.S. exchanges. As you can see on this chart, there are now 43 percent fewer companies traded publicly in the U.S. versus the peak in 1996, which I should point out was before the dot-com bubble.

Basically, we are not replenishing our public markets with new companies while at the same time, foreign exchanges are growing their listed accounts fairly rapidly.

What's driving these disturbing trends? There are a number of factors. David Wield, who is the former Vice Chairman of NASDAQ and the author of the Grant Thornton paper, points to four causes for this trend.

One is a transition to online trading away from the traditional retail brokerage model. Two is decimalization in the number of small cap companies covered by research analysts. Next is high frequency trading and the effect it has had on IPO allocations, and lastly, introduction of Sarbanes-Oxley.

Now that we have identified the downward trends that are affecting the public markets and their causes, why is this significant?

There is a positive feedback loop that results from recycling of capital in and out of private companies. When the system is functioning, it provides the ability for bright entrepreneurs to start new businesses, which leads to job growth, innovation and increased competitiveness in America.

With those sufficient exit options, venture capitalists and angel investors are unable to fund start ups, plus from the employee perspective, the value of their stock options, which is a significant part of their compensation, is viewed far more skeptically, which makes it more difficult for these companies to attract and retain talent.

IPOs directly lead to job growth in ways that M&A exits do not. When companies raise capital through an IPO, they often times use it to fund growth, but in contrast, acquisitions often lead to cost cutting and job losses.

In fact, a more recent Grant Thornton study showed that 20 million jobs were not created as a result of the broken public markets.

In addition, an IPO is often times the most logical exit option for private companies who don't have a logical acquirer or as Andrew mentioned, the management teams just don't want to go public and lose control of their business.

Think about it for a second. What would have happened if Google, Apple or Intel had decided to sell their companies instead of going public?

For all these reasons, the U.S. will continue to lose competitive grounds to foreign capital markets unless changes are made to address the breakdown in the capital formation process.

As you might expect, the entire venture ecosystem is looking for answers and the incumbents are interested in new ideas. However, the solution needs to have a scale to address the vast complex issues at hand.

In April of this year, the NVCA released what they called a "four pillar plan" with the stated goal of restoring liquidity to the U.S. venture capital community.

As part of this plan, the NVCA identified four areas of focus. One, to promote the next generation of investment banks and other professionals to serve the smaller cap companies.

Next, they suggested to provide certain tax incentives, incentives to support and promote growth companies. Next, to review and update certain regulations, and finally, to promote alternative paths to liquidity.

Under this last pillar, the NVCA made mention of four efforts to address the secondary trading of private company securities. Mentioned were SecondMarket, the Portal Alliance, which was once called NASDAQ Portal, Xchange, which is a start up backed by Tim Draper, and lastly, Inside Venture, which is a company that we acquired about a month ago.

How did SecondMarket get involved? Seeing the need for a solution, we spent nearly 12 months meeting with private companies, venture capitalists, lawyers, and other key players in the industry to help formulate a private company model that provides for robust shareholder liquidity while also maintaining investor protection and complying with existing securities laws.

The model we developed could be best described as a tool kit for private companies. In the SecondMarket model, company management and/or board are able to fully control how this liquidity model works. This control includes things such as when transactions can take place, once a year, once a quarter, ongoing or maybe just one time, as well as how many shares a holder can sell at any given window.

The company also decides which potential buyers are allowed to participate. This could be a handful of selected investors by management or it could be opened up to the entire SecondMarket community of accredited investors.

Additionally, the company management also decides how much information and what information is shared with potential purchasers. This information is all shared behind a password protected wall, which gives companies additional comfort regarding the risk of information leakage, which is a significant concern for private company management.

As you can see, the model we have created is very similar to a traditional private placement process. The main difference is that we are using technology to make the process more transparent and more efficient for the companies, the sellers and the buyers.

As a registered broker-dealer, we work with companies to handle all transaction settlements, including compliance with accredited status certification, as well as new customer solicitation and investment intent rules.

To date, dozens of companies have started working with us. We have completed over $80 million in transactions this year, and have about $400 million in private company stock for sale in exciting companies like Facebook, TESLA, Twitter, LinkedIn, the well known venture backed companies. These numbers are growing very quickly.

Giving private companies the ability to stay private longer while also providing some liquidity to their shareholders is a very important part of the capital formation process.

We are very excited about what we are doing and are seeing tremendous traction, plus we now have the support of the NVCA, top venture capitalists, and lawyers.

Ultimately, it is our expectation that SecondMarket will either serve as a spring training for companies before they go public or in certain cases, an alterative to going public, recognizing, of course, that the level of liquidity in any of these SecondMarket platforms will not approach the level of liquidity of well seasoned large companies that trade on the public exchanges.

Although we have developed our model to comply with all regulatory rules, there are a number of areas that we think could be re-evaluated in order to promote the use and success of robust liquidity alternatives like this for venture backed companies.

I should point out that I borrowed some of these ideas from Grant Thornton as well as a number of securities lawyers that we have consulted with.

First would be to amend general solicitation rules. The idea here would be to allow companies and selling shareholders to market their securities more broadly. Currently, vetting of potential investors to assure they are accredited must happen before marketing, which limits the audience and most importantly, the means of communication, thus limiting the pool of potential investors.

Instead, vetting could occur at the time of purchase which would still protect retail investors.

Next, we suggest amendments to 144(a) rules to add accredited investors to the safe harbor. Currently, 144(a) allows for the purchase and resale of unregistered securities by QIBs only. Adding accredited investors to the definition would really help to drive liquidity to this market while also maintaining a high level of investor protection.

Next, regulators should review investment intent rules to allow for more active market making. Currently, a buyer of unregistered securities must purchase with what is called "investment intent." The problem is that there are no clear guidelines for how long you need to hold onto the securities to demonstrate investment intent.

As a result, broker-dealers are uncomfortable deploying capital out of fear they will blow the exemption when they re-sell their shares as part of a market making activity.

Finally, we recommend that the SEC either increase the 500 shareholder limit or exclude accredited investors from the count. As you know, a company must publicly file once it hits 500 shareholders. Given that it is taking much longer to go public, private companies will now tend to have many more shareholders than they have had in the past prior to an exit event.

As a result, the shareholder count limitation makes it very difficult for companies to use their stock as acquisition currency or for employee compensation in fear of exceeding this 500 shareholder limit.

In summary, a robust market for private company stock is an important part of the solution for business formation, job creation, and importantly, will help kick start the capital formation process.

Without a robust private market, we will undermine the development of small businesses, entrepreneurship, and ultimately U.S. global competitiveness.

Thanks.

MR. LAPORTE: Thank you very much, Barry. You have given us a lot of thought, and into the next panel, which is on the "accredited investor" definition, and given people a lot of thought who will be meeting this afternoon in the breakout groups.

Our next panelist is Anna Pinedo. Anna is a partner in the law firm of Morrison & Foerster LLP. She is based in New York City.

She is very knowledgeable in transactional securities law issues including those faced by smaller public companies.

Anna appeared as a panelist at this forum two years ago and she was a star and we're very glad to be able to have her back two years later for a reprise appearance.

Thank you, Anna.

MS. PINEDO: Thanks, Gerry. I'm going to echo a lot of the sentiments expressed by the panelists, which is capital markets are definitely improving, but it's still a very challenging market for companies that are seeking financing.

Meanwhile, it might seem that challenge is easier to overcome for companies that are already public, that already have what would appear to be a liquid currency in the way of listed securities. It's not necessarily the case.

Even though companies are waiting until they are more mature or more developed to go public, once they are public, being public doesn't necessarily convey or have all of the positive attributes that it once had in the sense that smaller public companies as a result of many market changes are finding it harder to raise capital to continue to fund their business.

And changes have arisen as a result of a variety of different factors, including market structure issues relating to fewer investment banks willing to take public smaller public companies.

There is less research and support for smaller public companies, and the liability associated with taking a smaller public company public is quite significant in the face of the compensation and cost of a public offering.

In any event, once a smaller public company has achieved that milestone of an IPO, it then faces the challenge of continuing to finance itself either through the public markets or by accessing private capital.

In terms of access to capital formation, the changes that were really promoted by the small business group including the shortening of the Rule 144 holding period, the easing of restrictions or limitations on the ability to use the short form S-3 registration statement, all of those were immensely important for smaller public companies, despite the difficult markets that we faced since those changes came into place, it still made a very notable difference in terms of how smaller public companies are financing.

In terms of smaller public companies accessing the capital markets, of course, there are the liquidity challenges that are the result of the financial crisis. There are also a number of challenges that again relate more to changes in the market.

Hedge funds and other investors that are financial investors as opposed to long term investors play a very significant role in the market, and a lot of the trading activity that we see once a public offering is announced has a very significant effect on the stock price of that company.

It's in part as a result of that and in part as a result of there not necessarily being a willingness on the part of investment banks to finance smaller public companies that many smaller public companies are looking to either exempt offerings, private placements, or a variety of hybrid financing alternatives that implement many of the same features usually associated with private placements in order to finance themselves.

Private placements for already public companies have sort of generically been grouped under the rubric of PIPE, private investment and public equity. PIPE is now understood to include a much broader array of financings as it once did.

For a very long time, a PIPE transaction meant a very particular kind of structure. It was really a private placement of an already public company made to selected accredited investors where the issuer would commit to have declared effective a resale registration statement covering the resale from time to time by the investors who participated in the PIPE transaction of the shares they purchased.

What is attractive about that as a means of financing in large measure, is that an already public company doesn't have to announce the financing transaction until there is certainty regarding completion of the financing.

Going back to my earlier comment, in a volatile market, that's incredibly important to a smaller public company and to public companies generally, avoiding front running or irregular trading that comes with the announcement of a potential financing.

The meaning of a PIPE transaction has been broadened to include an array of other transactions, such as, for example, private placements with delayed registration rights, private placements involving convertible or more structured securities, venture style or change of control PIPE transactions.

As we have been hearing, there's been a melting and a migration of investors. Venture capital, traditional venture capital investors in the past were reluctant to invest a significant portion of their funds in already public companies, having always taken the view that they wanted to be in on the growth of the company, not once the company was already public, missing an opportunity there for return on their investment.

What we are seeing is that with the market prices of smaller public companies having been eroded, venture capital investors or traditional VCs are finding there is opportunity still for them investing in existing public companies where the stock prices make those investments quite attractive.

In the context of such an investment, again, there is a blurring of lines. We are seeing that already public companies are agreeing with VCs in the context of a venture change of control PIPE transaction to operating covenants and other contractual limitations that again one would associate with a much earlier stage investment.

In addition to PIPE transactions, which is really as I said a private placement of an already public company, there are another series of hybrid transactions that many smaller public companies are turning to.

Those include registered direct offerings for companies that are eligible to use a shelf registration statement, even if it's a smaller shelf registration statement for those that are under $75 million.

Smaller companies are working with financial intermediaries to style offerings as take downs off those shelf registration statements. In the case of a best efforts take down, often referred to as a registered direct, the offering is targeted to specific institutional or a smaller group of institutional investors.

In the case of an underwritten transaction, what we are seeing is that many financial intermediaries are pre-marketing or wall crossing investors, and a lot of the core selling to a smaller group of institutional investors that have been vetted and have entered into confidentiality undertakings.

There are two different types of deals that I described, a registered direct or a pre-marketed or wall crossed public offering. They are really marketed like a private transaction or a PIPE transaction. That is, they are marketed without there necessarily being transparency to the marketplace generally until a deal is consummated, and the advantage there is that issuers don't face the same exposure in terms of volatility, shorting, et cetera, in their stock.

We are also seeing that a number of companies during the last year have turned to rights offerings. For a very long time, rights offerings were not very common in the United States. They were and have been very popular in Europe where public company stockholders frequently have preemptive rights.

As a function of financing, rights offerings are an essential component to a financing.

What we are seeing here in the rights offering area is that companies understand their stock is under valued, know their investor base would be interested in acquiring more, a bigger stake in the companies.

Many times investors feel like they didn't have adequate opportunity where a company has done a PIPE transaction and they would have liked to have participated, so rights offerings bring a certain quality and level the playing field for smaller public company investors.

Also, if paired with a standby purchaser, a rights offering can at least provide or secure for a public company a significant amount of capital.

In choosing among these alternatives, I have too little time to discuss the various benefits or advantages and the disadvantages associated with each transaction format that I covered from a private to a PIPE to a registered direct, a pre-marketed or wall crossed public deal or a rights offering.

The basic point that all of these transactions have in common from my perspective is that while still offering smaller public companies an opportunity to finance and to do so in a way that is efficient, it still requires that a company face or overcome a number of impediments.

First, from the public/private perspective, more and more we are seeing that public companies cannot raise all of the capital that they would like to raise in one particular offering. Their financing plan or their financing objectives may require that they do a number of different offerings within a relatively close period of time, in relative proximity to one another.

Given the fragility of the markets, it's often not clear which transaction will be able to be accomplished.

We are facing a number of questions from clients in terms of completing private placements and public offerings, or attempting to commence a public offering not necessarily being able to complete it and then having to resort to an alternative financing.

I think that in terms of providing guidance on a lot of these questions, public and private financings, the SEC's disclosure interpretations that came out late last year and early this year have been very, very helpful. I think there is more certainty for practitioners in terms of thinking about gun jumping issues, general solicitation questions, and integration questions, but I think there are still ample opportunities to achieve greater clarity on integration questions, as well as on general solicitation questions.

The other issue that I think about as closely related to that is that the smaller public companies that are able to use an S-3 but only up to a certain limit for their primary offerings continue to face challenges in the sense that the one-third cap doesn't necessarily take care of all of their capital needs.

While it seems like we have had a good period of testing that out with some success, it may be worth revisiting the notion of that cap on the use of Form S-3 for smaller public companies.

What we are seeing is that many smaller public companies facing that hurdle are opting to do some transactions as take downs off their shelf registration and then looking to one of these other alternatives of private or PIPE, et cetera, to get them to their number.

The interaction of all of those rules are worth looking at because from a practical perspective, they continue to pose some interesting questions for issuers and for practitioners.

The final point is that for all of these smaller public companies, whether they are NYSE listed or NASDAQ listed, they all face what folks refer to as the "20 percent rule."

That's that the NYSE and NASDAQ, although the rules are differently worded, somewhat different in practice, impose on listed companies an obligation to seek shareholder approval in connection with certain actions, in connection specifically with a private placement or private offering that's completed at discount to book or market, which would result in an increase in the total shares outstanding of 20 percent prior to the transaction having taken place.

The rules also impose shareholder vote requirements in connection with financings that take place for the purpose of financing acquisitions, as well as for transactions that take place in connection with or that affect a change of control.

As I mentioned when I started, a lot of these transactions for already public companies, be it a PIPE or a pure private, involve a private financing, and given current market circumstances, it's difficult to tackle the discount issue.

It's also difficult in the context of a registered direct offering, which for SEC purposes, is quite clearly a public offering.

The stock exchanges focus principally on the nature of the distribution, so both exchanges have interpretive guidance that would suggest looking at a variety of factors, and it's essentially a strike against the transaction if it's not fully underwritten. In other words, if you have a transaction that's completed on a best effort basis.

Navigating all of these rules can be quite challenging for smaller public companies that face urgency in terms of their capital raising needs.

Nonetheless, I think what we have seen in 2008 and thus far in 2009 is that there is a very robust market for PIPE transactions as well as for hybrid securities offerings, including registered directs, over the wall transactions, and even rights offerings, despite their relative unfamiliarity for U.S. investors and U.S. public companies.

I am going to leave things on that hopefully somewhat positive note.

MR. MOUTRAY: Thank you, Anna.

QUESTION AND ANSWER SESSION

MR. MOUTRAY: We have received two questions via e-mail. Again, that is Smallbusiness@sec.gov. I will turn to those. I think we have ten minutes for questions.

What role does the panel think that reverse mergers and self filings can play to build liquidity and why do you believe that venture firms have shun these options even though 200 companies a year go public this way, and include businesses like Blockbuster, Berkshire Hathaway and Texas

Instruments?

MS. PINEDO: I think that reverse mergers are obviously an option in terms of a company that's seeking to have stock that is publicly traded, stock that's essentially a currency. However, we always counsel clients there are a number of issues to be aware of in connection with reverse mergers.

I think the SEC has been focused on reverse mergers for quite some time, simply because there is the opportunity for abuse in many respects in connection with reverse mergers. It's very, very difficult to find a pristine company to merge with or into.

Of course, once a company completes a reverse merger, there are a still a number of impediments from a regulatory perspective to how they conduct themselves and how they conduct their business.

While it may seem like an attractive and relatively quick way to obtain a listing and have a public security, it does come with a lot of baggage.

MR. SHERMAN: I would very much agree with Anna's comments. The degrees of due diligence, both strategic due diligence and financial accounting due diligence are very severe.

The number of truly pristine shells or reverse merger candidates compared to those that do have a lot of baggage or hair or whatever other terms are sometimes used is still out of whack in terms of the ratios, and while the questioner raises some of the few sort of great examples that have come out of that, there is still many transactions that have been problematic.

I think it is a reminder to consider all options that are available but also to get good counsel and to do the right due diligence if you're going to consider one of these alternatives.

MS. PINEDO: I think although the IPO market may not be functioning as well in certain respects as it once was, the point of having an IPO and having a financial intermediary who acts as a gatekeeper and having that process of due diligence and discovery serves a very, very useful function from the disclosure perspective and a screening perspective.

There is a lot of value that has to be attributed to actually accessing the markets in that way.

MR. MOUTRAY: Thank you. Moving on to a completely different topic here, this is a question that says do you feel that big banks have failed small businesses, particularly those that have received TARP money in the United States?

This particular questioner feels that big banks have been -- for those receiving TARP money or receiving dollars at low cost of capital, they are not lending to small firms.

Does anyone want to comment on that?

MR. ZARNIKOW: So, does anybody want to comment on that? I guess what I would say about that, and I think what we have heard from other people on the panel as well as what we see in the data that's out there in the senior loan officer opinion survey, is that really several things have been going on out there and it's difficult to get a clear answer.

One is what is the demand for loans, and when I talk about demands for loans, I talk about it from creditworthy small businesses.

Second, you have seen clearly that there has been a tightening of credit standards when you look at the senior loan officer opinion survey, and I think that generally, when you talk to folks and you think about small business finance, I mentioned earlier there tends to be a blurring between the finances of the owner of the small business and the small business itself, and there has been many things that have impacted the creditworthiness of small businesses.

There is the downturn in the economy. Many businesses are challenged with profitability, with revenue. In many cases, that collateral value that may support the small business has declined whether it's home equity that was put up as part of financing the business or whether it's commercial real estate or other equipment that is part of the small business.

I think it's really a very complex question to answer in that there isn't a very clear answer around that.

MR. MOUTRAY: Before Andrew answers, I have another question from someone in the audience which is related.

It says SBA, why the decline in October 2009 -- I think they mean 2008 -- for 7(a) and 504 loans?

MR. ZARNIKOW: I think there are several things really when you look at what happened last Fall. There was really a very broad freezing of credit markets. We saw an unusual situation where LIBOR rates, basically the rates that are set for banks to borrow amongst themselves, really took a very strong upward movement. There was a lot of uncertainty in the credit markets. There was a lot of uncertainty about the survival of banks.

If you recall that time period, you had earlier in the year the situation with Bear Stearns. You had Lehman Brothers going bankrupt. You had a number of large financial institutions that were basically acquired or merged over weekends.

It was a very disruptive time in the credit markets. I think there was a broad pull back in the SBA secondary markets. Specifically our underlying loans are typically priced off a prime rate base, but the investors who buy the loans typically borrow or are funded off the LIBOR base.

With the disruption in the financial markets, we saw a situation where the normal prime-LIBOR relationship is the prime rate is about 300 basis points higher than LIBOR, and we actually saw a period briefly where the LIBOR rate exceeded the prime rate.

As a result, investors were upside down on their investments in SBA loans.

I think the freezing of the second market for SBA loans definitely impacted lending volume. I think some of the broader disruptions in the credit markets and what was going on with the liquidity of financial institutions also impacted the market last Fall.

MR. MOUTRAY: Andrew?

MR. SHERMAN: Yes, two quick comments. One, when I look at the small business commercial lending market right now, I'm reminded of an old high school dance where the boys are all lined up on one side and the girls are on the other, and neither will ask the other to get things started.

I have commercial lending officer friends at large and medium sized banks, and they complain about a lack of quality deal flow, lack of preparation in loan proposals, lack of collateral, as you mentioned.

I have small business clients who claim that the credit standards are too high.

I think we just need to get the music started and get these folks dancing.

The second thing is there may be a mismatch between big banks and small companies right now, and the people that are filling the gap are the smaller community banks, the local banks, the credit unions.

We had a panelist last year, a commercial lender from Northern Indiana, who on this very panel, and some of you were here, said we've got money, we're running out into the communities begging our community to borrow from us. We have too much money to lend and no one to lend it to.

I think there is a fair bit of whining going on here and I think we need to cut through the whining and get to the transactions.

MR. ZARNIKOW: One other thing I would add coming out of the conference that SBA and Treasury hosted yesterday is I came away with sort of a feeling that -- I mentioned earlier that the feeling is the markets are recovering but they are still fragile, and I definitely got that feeling in listening to and talking with lenders yesterday.

There's a feeling that there is sort of a cusp point going on right now in the economy where the economy is beginning to recover out of the recession. Now is the time for lenders to be able to step up and lend.

The challenge obviously is looking backward in the rear view mirror. A lot of times results that small businesses have had haven't been as strong, but there is also a big opportunity for lenders now to gain market share where others have stepped back.

There were several lenders that we have who have announced large commitments in growth and small business lending. One of the major financial institutions recently announced a big commitment to increase small business lending by over 40 percent or $4 billion.

I do think also that community banks, credit unions and non-depository lenders are very important sources of capital as well for small businesses.

MR. LAPORTE: I think we have several other questions here but I don't think we are going to have the time to ask them. We want to be back in this room at 11:00 so we stay on the schedule today.

I want to thank all the panelists and Commissioner Paredes, and in absentia, Chairman Schapiro, for being here today. I think this has been an excellent panel.

We look forward to continuing to work with you in the future on resolving some of these difficult issues of small business capital formation that we are facing in the next couple of years.

Thank you very much.

(Recess.)

INTRODUCTION AND REMARKS BY COMMISSIONER TROY PAREDES

MS. CROSS: We should get started again. I hope everyone enjoyed this morning's discussion. I am pleased to now introduce Commissioner Troy Paredes.

Commissioner Paredes joined the SEC in 2008. Before his appointment, he was a tenured Professor at Washington University School of Law in St. Louis, where he primarily taught and researched in the areas of securities regulation and corporate governance.

Commissioner Paredes has researched and written on numerous topics such as private placements, hedge funds, the psychology of corporate and regulatory decision making, alternative methods of regulation, comparative corporate governance, and the law and business of commercializing innovation.

He is a co-author of a multi-volume securities regulation treatise with Louis Loss and Joel Seligman.

Prior to joining the faculty at Washington University, Commissioner Paredes practiced law at prominent national law firms on a variety of transactions and legal matters involving financings, mergers and acquisitions, and corporate governance.

Commissioner Paredes' extensive knowledge of the securities laws and his strong interest in small business capital formation gives him a real basis for understanding the unique challenges faced by small businesses.

Without further delay, I'd now like to introduce Commissioner Paredes.

(Applause.)

COMMISSIONER PAREDES: Thank you, Meredith, for the kind introduction. It's a pleasure to be here today at this important gathering to discuss capital formation for small business.

I, too, would like to welcome today's attendees, both those here in Washington and those participating by Webcast. I also would like to thank our distinguished panelists for making time in their busy schedules to participate today. Your input truly is invaluable.

Of course, thank you to the many members of the Commission's staff who have made today's forum possible, with a special thank you to Gerry Laporte.

Although attention often seems to focus on larger enterprises, we need to appreciate that small and emerging businesses offer unique opportunities for investors, entrepreneurs, employees and consumers.

Smaller companies, however, also face distinct challenges and hurdles. Today's discussions will highlight some of the difficulties facing small business, particularly given the current economic climate.

The observations and highlights that flow from forums like this help us craft an appropriate regulatory framework over time. In practice, the regulatory regime may need further tailoring to ensure that it is appropriate for companies of different sizes.

A small firm should not necessarily be subject to the same regulatory demands that a Fortune 500 company is required to shoulder. Among other things, one needs to consider the disproportionate burden that a given regulatory requirement can impose on a small business and the costs we all bear if as a result businesses struggle to get off the ground or expand.

When a small business can't secure funding at a reasonable cost, for example, the economy is deprived of the firm's full participation in the marketplace.

There is a long-standing tradition of scaling Federal securities regulations in important respects to provide small enterprises relief from select burdens that may be especially challenging for them.

Consider Section 3(b) of the '33 Act, authorizing the Commission to adopt rules exempting certain small offerings from the demanding and time consuming registration requirements of Section 5.

Under Section 3(b), the Commission has adopted Rules 504 and 505 of Regulation D. By allowing an issuer to forego a statutory prospectus and registration statement, these rules facilitate capital formation for start ups and other small companies long before they even consider going public.

Rule 506 also has encouraged small business capital formation by providing certainty and predictability in the form of a safe harbor under Section 4(2) of the '33 Act.

As recently as 2007, the Commission adopted a host of reforms designed to ease the regulatory burdens smaller companies face and otherwise to achieve regulatory simplification for such firms.

The Commission also expanded the number of companies that can avail themselves of the more streamlined and efficient regulatory regime.

These reforms further evidence that Federal securities regulations and SEC rulemaking in particular can be fashioned in order to accommodate the unique features of small business while continuing to ensure that investors are protected.

In my view, the Commission should actively consider other ideas for refining securities regulations so as to encourage small business capital formation. Start ups and other small businesses drive innovation, spur job creation, and provide opportunities for investors to earn higher returns. New and smaller enterprises deliver cutting edge goods and services to our economy and pressure more established companies to compete more aggressively.

When properly tailored, the securities law regime can avoid unduly impeding small business as an essential source of economic growth and wealth creation.

The next panel, Academic Perspectives on the Commission's "Accredited Investor" Definition, is sure to be a source of ideas that will shed light on today's important topic. As a law professor myself, I look forward to the discussion.

With that, I turn things back over to Meredith and Gerry to begin the next panel and thank you very much.

(Applause.)

PANEL DISCUSSION: ACADEMIC PERSPECTIVES ON THE SEC'S DEFINITION OF "ACCREDITED INVESTOR"

MR. LAPORTE: Thank you, Commissioner Paredes. As the Commissioner mentioned, the next panel is on Academic Perspectives on the SEC's Definition of "Accredited Investor."

Meredith Cross will serve as co-moderator with me for this panel. Meredith re-joined the SEC's Division of Corporation Finance this year as Director of the Division after an 11 year absence from the SEC.

During that absence, she practiced law at the firm now known as WilmerHale. Meredith was a staff member of the

Division of Corporation Finance for eight years before she joined WilmerHale, serving in increasingly responsible positions up to the position of Deputy Director.

She's a good person to lead the Division containing the Office of Small Business Policy because she's extremely familiar with the issues we deal with on a daily basis.

Meredith?

MS. CROSS: Thanks, Gerry. I'm delighted to introduce our panel today, distinguished securities professors. I am going to introduce them in alphabetical order, and introduce all of them before they start talking.

We have Rutheford Campbell. He's the Everett Metcalf Jr. Professor of Law at the University of Kentucky College of Law. He teaches and writes in the areas of corporations, securities regulations, corporate finance, and law and economics.

Professor Campbell testified at the SEC hearings that led to the adoption of Regulation D and at the Congressional hearings that led to the enactment of the National Securities Markets Improvement Act of 1996, or NSMIA.

Jill Fisch is the Perry Golkin Professor of Law and co-director of the Institute for Law and Economics at the University of Pennsylvania Law School.

Professor Fisch teaches corporations, securities regulation, corporate governance and Federal courts, and her scholarship on those topics has appeared in a variety of law reviews.

Her recent projects examine loss causation in securities fraud litigation, the role of proxy advisors, and securities arbitration.

Donald Langevoort is the Thomas Aquinas Reynolds Professor of Law at Georgetown University Law Center here in Washington, D.C.

Professor Langevoort has written a treatise on insider trading, co-authored a case book on securities regulation, and produced numerous law review articles on topics including insider trading, the impact of technology on securities regulation, investor behavior and the intersection between cognitive psychology and lawyers' professional responsibilities.

William Sjostrom is a Professor of Law at the University of Arizona James E. Rogers College of Law where he teaches business organizations, securities regulation, and mergers and acquisitions.

Professor Sjostrom has published several law review articles including on the topics of equity capital and share liquidity for private companies, Rule 144(a) equity offerings and the prohibition of general solicitation and advertising in private placements.

With that, I'll turn it back to Gerry to get the discussion started.

MR. LAPORTE: We sort of have an arbitrary way for the order in which we are going to have this panel give their presentations. We had a telephone call on Monday to make sure we didn't have any overlap. We are going to do this in the order in which they responded during the telephone call on Monday. Actually, we decided that afterwards.

With that, we are going to have Don Langevoort go first. Don?

MR. LANGEVOORT: I spoke first. I actually know this rule and know if you speak first, then other people can't steal your stuff. That's me.

It's a delight to be here and talk about the relationship between the "accredited investor" definition and concepts that we are very familiar with under the Securities Act, particularly the notion of investors who are supposedly able to fend for themselves.

As Commissioner Paredes knows very well, there is a delight that law professors get when they teach securities regulation, on the day you do Ralston Purina because you can call on students and get them very quickly to hone in on the phrase "not needing the protection of the securities laws, able to fend for themselves," and then you can instantly tie students in knots of self contradiction by asking them what does that mean.

There are predictable answers, all of which are wrong, and second thoughts, which are even worse. After about five minutes of some entertainment for the rest of the class, the students are very well positioned to understand what motivated and what justified the SEC's move in Reg D and the move toward accredited investor status statutorily, toward a more objective approach. The question of who can fend for themselves is largely unanswerable.

The reason is it has both descriptive and normative dimensions to it. The natural reaction to the question who can fend for himself or herself, is the person with enough sophistication and knowledge? So far, so good. To do what?

To be able to run a financial analysis that lets you arrive independently at an appropriate valuation for the security? If that's the answer, virtually none of us fit into that category.

Enough to know that if you don't understand the security that's being pitched to you, you ought to leave the room? Well, descriptively, that's not many of us. Normatively, however, if we posed the question who would be expected to fend for themselves, who should be asked, maybe that, do you know enough to leave the room when you don't understand the security should be nearly everybody.

We see very quickly that as you start asking the more specific questions, the phrase "who can fend for themselves" becomes largely meaningless.

As I suggested, I think some value comes from talking about that question descriptively and normatively.

Descriptively, if you think more what's going on in the question of who can fend for themselves, who has the lack of dependency, the lack of need to depend on the issuer as a source of information, to be able to construct the investment -- reconstruct the investment decision on their own.

Here is what I'll be talking about over the next few minutes and I want to keep this very short so we can have lots of discussion.

To ask the question descriptively who is able to do that, we need to do empirical research. We need to look at how investors actually behave when questions like this are posed.

A lot of the research that has appeared recently is in the guise of what we call "behavioral economics," integrating psychology and economic behavior by doing both laboratory and field research into what people actually do.

In the last few years, the Commission has become more interested in behavioral economics and the integration of psychology and economics, and I want to talk about how some of this research might help the Commission think through the "accredited investor" definition in a minute.

On the other hand, the other way of looking and frankly my preferred way of looking at accredited investor is normatively. I don't think ultimately that descriptive question, who is going to get it right, gets us close to a meaningful test.

If we ask who ought to be expected, we could ask things like is the role of wealth meaningful apart from sophistication, does the ability to fend for yourself speak not only to cognitive ability but the ability to absorb risk and learn from experience.

I'll be addressing both of those as I talk about some of the research.

With respect to what we know about investor psychology and investor decision making, we first of all have to observe the problems that plague an investor faced with an unregistered security offering, a lack of mandatory information about it. It is not limited to cognitive or biased based decision making.

Few of us have the time, the ability to sit down and spend the time necessary in order to gather all the information that might be relevant and process it. Many of us depend on others to do that work for us. When we start depending on others, conflicts of interest, agency cost problems, start emerging.

Those are pretty familiar problems. They are certainly thought about in Reg D. I want to focus back on investor psychology and investor decision making.

Point number one, and for the benefit of the staff and anybody here, I have references and citations to the research I'll mention so nobody has to try to scribble down names of authors and risk getting it wrong.

First of all, we do know that there is some correlation, positive, helpful correlation between wealth and the quality of investment decision making. As wealth increases, the reliance on pure heuristics and poor biases diminishes. That is a rough correlation. That is not to say as you get richer, you get smarter. It's rather as people get richer, the appearance of smart is more frequent. We will start there.

A second insight is there is a correlation, again, positive and helpful, between age and sophistication. As people get older, and this seems to be the product of learning by experience, the reliance on heuristics and biases that distort good decision making goes down.

Unfortunately, as two academic researchers, Cornitus and Kumar, in a recent paper point out, that learning from experience and that improvement with age hits a stopping point. That is to say at some point the decline in cognitive ability that all of us getting older tend to notice can overwhelm the beneficial effects of learning from experience.

There is an age of about 45 to 60 in which investment decision making is optimized, but unfortunately, at other ends of the spectrum, you can't be so convinced and so sure that investment decision making is as good as it should be.

This, of course, plays importantly into what separately is very important to the Commission, which is concern about senior citizens' investment decision making. It would be nice to say older investors don't quite need as much protection under the securities laws because they are experienced and the cumulative effect of learning over the course of a lifetime has improved, but the message of this research is there's going to be a point at which even wealthy, highly experienced investors begin succumbing to difficulties that make it less likely that what we would hope to observe of fending for one's self will occur.

Finally, we have a lot of research on the relationship between literacy and sophistication. Does education and training in financial analysis and basic terms of finance improve investment decision making and move people away from heuristic and biased based research?

Here, it is very hard to be optimistic. A detailed study for London's Financial Services Authority that was just published last year as well as some research in the United States finds a relatively poor correlation between training and education and good investment decision making.

Many of you are familiar with research done three years ago for what was then the NASD, now FINRA, supported by the AARP, which was a careful look at the susceptibility of senior citizens to investment fraud in which they rather imaginatively gave their sample of senior citizens a quiz to test their financial literacy and then measured it against the extent to which that same group of persons had been taken advantage of or scammed, and found actually the more knowledge you had, the more likely you would be taken advantage of.

A little knowledge is a dangerous thing. Maybe if you realize you don't know, you're quicker to leave the room when a salesman starts talking as opposed to what this person who has this false sense of confidence about their literacy or knowledge knows.

This is some of the research that is out there. It is not terribly encouraging about the ability to pick a wealth figure that is a good proxy for sophistication or ability to fend for themselves.

I'll leave and turn it over to the other panelists largely by coming back to what I said at the outset. The more I think about fending for one's self or an accredited investor, the more I'm convinced it should be a normative judgment, it should be a judgment about who should be expected to fend for themselves and to be careful, to exercise due diligence as opposed to who will.

I think wealth clearly correlates with the ability to bear pain, to learn from one's experiences, to the extent as Commissioner Paredes said, what we really have to do in the small business financing area is make tradeoffs. Capital formation on the other hand and the need to promote innovation with the need to have reasonable investor protection, that there is a place for a wealth based standard, even in the face of the concerns about the research that I described.

I think personally that our current standard for accredited investor with respect to wealth is too low. I would raise it somewhat, but not extensively, and I think having done that, I would say the remaining task to be done is to look at sales practices within the small business financing area, I think in terms of FINRA or the SEC, a special set of rules about investor qualifications and the selling of unregistered securities.

MS. CROSS: I'm curious. On the discussion about wealth, when wealth is evidenced by securities investment, which I think has been a focus of some discussion on how we should view the "accredited investor" definition -- should it look at people who have a lot of money versus those who have a lot of money and buy securities, so they have some experience.

Is that anything that has been considered in the definition of "wealth," or do you have thoughts on that?

MR. LANGEVOORT: In order to make an investment based definition of "wealth" usable, I think it is quite doable but I think you're going to have to do a couple of things in order to get it right.

First of all, retirement wealth has to be viewed separately from other kinds of investment wealth. The experience that brought you the lump sum 401(k) pay out when you hit a certain age isn't the experience of building your own actively managed investment portfolio.

If you take that together with some of the other things I said about the effects of aging, I don't think we want to say that retirement wealth should count to it.

Wealth that you built yourself, that gets it pretty nicely, but only after a period of time, and again only if you accept the dimension to the exercise that this is only to be a rough correlation with good decision making rather than a precise one.

MR. LAPORTE: Professor Sjostrom?

MR. SJOSTROM: Thanks, Gerry. I, like Don, am delighted to be here as well. I'm going to talk about the connection between the definition of "accredited investor" and general solicitation.

Chairman Schapiro in her speech this morning started off by talking about the three aims of the SEC, investor protection, integrity of the marketplace, and capital formation.

General solicitation in particular, I think, really illustrates the tension that we often see between the aims of investor protection and capital formation, in part because of the SEC's broad interpretation of what may constitute general solicitation.

Basically, the SEC has taken the position that if you solicit an offering, anyone with whom the issuer or agent of the issuer does not have a preexisting substantive relationship with, you may have engaged in general solicitation, even if we're talking a handful of people.

Presumably, this really strict definition of "general solicitation" prevents some fraud, prevents some investors from making unsuitable investments, but unquestionably, it makes it more difficult for companies to raise capital. That is really the tension.

We have a strict rule that at least presumably protects investors, but at the same time, it really has a negative impact on capital formation.

Historically, at least in the context of Rule 506, the ban on general solicitation has been necessary because of the regulatory framework. Rule 506 is essentially a safe harbor and 4(2) exempts transactions not involving a public offering, and the Commission has stated on a number of occasions that general solicitation simply imparts a public component to an offering, and therefore, is inconsistent with Section 4(2).

Furthermore, we have the 1953 case, SEC vs. Ralston Purina, which Don was talking about. In that case, the Supreme Court was fleshing out the scope of Section 4(2) because the term "public offering" is not defined in the Act, and basically as Don mentioned, what they said is an offering falls within 4(2) if it's limited to offerees who do not need the protection of the Act and/or can fend for themselves.

This is really the genesis of the substantive relationship requirement that the SEC has drafted upon the ban on general solicitation because Ralston Purina focuses on offerees, not purchasers, and since Rule 506 is adopted under Section 4(2), it has to be done consistent with Ralston Purina.

The SEC achieved that, it seems to me, by basically requiring the issuer and issuer's agent to be familiar with all the offerees so that they are in a position to determine sophistication, which of course, is a euphemism for the ability to fend for themselves.

That is kind of the framework of why we have a ban on general solicitation, at least when it comes to Rule 506.

It comes down to Ralston Purina's focus on offerees versus purchasers.

The definition of "accredited investor" comes into place because accredited investors are assumed to be sophisticated. Whether that's correct or not, I'll leave to other people. Keep in mind that a tightening of the "accredited investor" definition also tightens the ban on general solicitation.

As a result, we would be tightening not only the pool of potential purchasers but the pool of potential offerees as well.

Like I said, the ban arguably makes sense in terms of the historical regulatory framework but in 1996, Congress reformed the framework by adding Section 28 to the '33 Act and Section 28 provides general exemptive authority to the SEC, really very broad exemptive authority.

As a result, in my view, the SEC is no longer tied to the kind of Ralston Purina framework when it comes to setting the parameters of Rule 506. They no longer have to be faithful to that framework.

As a result, I think very clearly it would be possible for them to get rid of the ban entirely. I certainly join the chorus in doing so, but that is not what I want to focus on in particular here.

One approach not seen before would be more divorcing the ban on general solicitation from the definition of "accredited investor," and kind of moving away from that idea that we need a preexisting substantive relationship in order not to have general solicitation.

Here's what I mean by that. I'll provide an example. This example comes from in the matter of Kenman Corp. It's a 1985 SEC ruling. In this particular situation, there is this company, Kenman Corp., that was trying to raise financing with respect to some limited partnership offerings, so to do so, they put together an information packet which included a cover letter, a promotional document, and a reply card to request a personal sales meetings.

They sent this out to a number of people including people who had participated in prior offerings of Kenman. They looked at annual reports of 50 Fortune 500 companies and obtained the names of executive officers, and sent it to them. They went through a list of people who invested $10,000 or more in real estate offerings, and sent it to them. They sent it to some physicians, and finally, they sent it to a list of managerial engineers at Hughes Aircraft.

The offering ended up being successful. It says here they were sold to 39 and 25 investors, respectively, but unfortunately, they got in trouble with the SEC. The SEC got wind of what they were doing here and determined that their sales activities violated the ban on general solicitation.

They clearly did in light of their preexisting substantive relationship requirement because they didn't have a preexisting substantive relationship with all these people. Presumably, they didn't even know how many people they sent the materials out to.

There is really no way for them to prove that requisite relationship, so as a result, they were found to have violated the ban.

If you think about it, certainly what they did, I don't think could be described as a public offering. It was a very targeted mailing to people who, you know, at least in simplistic nature very well may have been accredited, it wasn't like we were talking hundreds and hundreds of people.

As I said, because of this connection between an accredited investor and general solicitation, because of Ralston Purina, I think the SEC really had to conclude that there was a violation of the ban on general solicitation.

My suggestion would be to disconnect those concepts. Section 28 is there, no longer does Rule 506 have to be built around Ralston Purina. It would be extremely helpful if the Commission, assuming the Commission is not willing to go all the way and get rid of the ban entirely, it would be extremely helpful if it was loosened up, perhaps a safe harbor put in place where you pick a number, you can solicit up to 200 people and we won't view that as general solicitation. You know, the devil would be in the details.

It strikes me that what Kenman Corp. did here shouldn't really be a big concern. Unfortunately, it is, and as a result, it's very difficult for companies to raise capital in the private placement market.

I do want to talk briefly about proposed Rule 507 where the Commission does rely on Section 28, and for those of you who are not familiar with 507, I think it was proposed in 2007 as a new exemption that would allow an issuer to engage in limited general solicitation so long as only large accredited investors took part in the offering.

"Large accredited investors" is a new term. The proposal defines them as people with net worth of $2.5 million or more or income of $400,000 or $600,000 with their spouse.

It's similar to the current definition of an "accredited investor," but with higher thresholds.

Unfortunately, in my mind, the problem with this rule is that it continues the connection of accredited or large accredited standards and general solicitation while really there's no real justification for doing that.

Why should it matter how people are brought into an offering? Shouldn't we just care about whether the people who actually purchase are making the right decisions and what not?

The other thing about 507 is -- maybe this is a political compromise, and I'm assuming it's such, because it really does not go very far at all. It only allows very limited general solicitation, essentially a company has 25 words. That's pretty much it.

In my mind, it strikes me as a pretty much worthless exemption because a company is going to have to make a tradeoff, if it decides to go the Rule 507 route and put out this limited general solicitation, it's going to forego any non-accredited investor, the 35 non-accredited investors it could have taken under 506. It's going to forego the accredited investors that don't meet the large accredited investor standard because the rule says you can only take large accredited investors.

The additional problem is you can't change course midstream. If you are in the middle of your 507 offering and you notice there is a fair amount of accredited but not large accredited investors who are interested in investing, you can't take them, because you can't switch over to a 506 offering because you've engaged in general solicitation.

Therefore, by going 507, you're locked out of doing a 506 offering for six months, basically, because of integration concerns.

In taking all those things into consideration, I don't see anyone using that exemption. The only reason you would use it is if you thought for some reason putting out a flyer with your 25 words would attract an investment by a large accredited investor that you wouldn't have otherwise attracted through a regular 506 offering.

In connection with revisiting this definition of "accredited investor," I think the issue with respect to general solicitation, Rule 507 and the like, should be revisited as well.

I also would like to stress the broad authority that's available to the Commission under Section 28 that to date really hasn't been exercised. It seems to me when it was passed, Congress said that the limits under 3(b) should be raised from \$5 million to \$10 million under Section 28, and that was never done.

It's unclear to me why the Commission hasn't been more active with this new found power, and certainly it's something to keep in mind when tweaking the definition of "accredited investor," but more generally, the Commission could use it to kind of break away from this Ralston Purina framework which as Don pointed out, is largely indeterminate. You simply don't have to even go down that road any more because of Section 28.

MR. LAPORTE: Let me assume my commentator role a little bit here. I was one of the people who was involved in drafting 507, proposed Rule 507, I should say. You're right. There were a lot of political compromises made. If it were up to me, I wouldn't necessarily frame it in precisely the words it was framed in.

The 25 word thing, there's no limit in the rule, there would be no limit under the rule on the length of the advertisement. The 25 words only applies to the description of the business. You can have a 1,500 word letter go out to people if you wanted, granted, I think that the 25 words is still a little bit short.

I think if the Commission re-proposed it, it would probably increase, if it decided to keep a limit on the description of the business, but the 25 words is only the description of the business.

MR. SJOSTROM: Isn't that the key part of the whole thing though? I realize my 25 words was an over simplification, but isn't that where you are making your pitch to investors, when you describe your business, and you have to do it in 25 words? That's my point.

MS. CROSS: I think one point on this, the current Commission has not considered Rule 507, that's a proposal from two years ago. That would be my first point.

The second point one could consider is that the use of a 507 type announcement could be to get people to come talk to you as opposed to having it be the only way you go about doing your offering.

For example, one of the difficulties we face now is what do companies do if they want to put something online. If you put anything online, it's a general solicitation. It could be useful for that.

The point about using 28 to go and do a different kind of exemption certainly is a fair point. We then would need to make a different kind of investor protection finding because our job is to protect investors at the same time that we promote capital formation, so right now, having been through an awfully difficult time for investors, we have tough balancing to go through if we were to go look for another way to provide exemptions.

Certainly you would think we would only -- the staff would recommend exemptions that are consistent with investor protection, which generally speaking, if you're talking about not registering, these would be people that you don't think need our protection.

It's not too hard where you end up linking back up to notions of accredited investor. Granted, you don't need to have the general solicitation limitation if you use 28. That's certainly something important to think about.

I think, if I recall, 507 used 28.

MR. LAPORTE: Yes, it did.

MS. CROSS: I think these are all good points. I think the one thing for purposes of this group is to understand that 507 is a two and a half year old project that is not the current thing we are working on.

MR. LAPORTE: Professor Fisch?

MS. FISCH: Thank you for having me. I want to take us back to the relationship between the wealth and income limits and the definition of "accredited investor."

In doing that, I want to broaden our scope a little bit because the wealth and income limits as Bill said obviously figure in not just to the definition of "accredited investor," but we have proposals like the "large accredited investor" and the "accredited individual investor," "qualified purchaser," and so forth.

My remarks are common to those different definitions or proposed definitions.

Unlike Don, I am particularly skeptical of the correlation between a wealth limit or income limit and sophistication, but I think Don is absolutely right. A lot of it depends on the purpose for which you are using these limits.

Are you trying to gauge the investor's ability to access documents? If so, you probably are talking about a market power definition that's a lot more substantial.

In other words, could this investor walk away from the offering, would the issuer go after them and say oh, no, we'll give you more information, you know. Warren Buffett can do that. Your average investor, even with $2.5 million of investment assets, probably can't.

Are you talking about the ability to evaluate complex investments and make good investment decisions? Yes, you have the wealthy professional athletes and rock stars and so forth who don't necessarily have sophistication in that classic sense, but those same individuals might qualify as the kind of investor who can bear risk or at least afford to lose money without being destitute.

I think the purpose for which you are evaluating really matters.

The correlation or what I think of as the weak correlation between wealth and sophistication, I think, is even stronger if you look to the more refined definitions of "wealth" that the Commission has been considering.

For example, some of the proposals talk about excluding your personal residence from the definition of your wealth or the definition of your assets. When I think about somebody with a $1 million home and they could refinance, take out a second mortgage, have $1 million in investable assets, versus somebody who has a fully paid off home, has no mortgage debt, which of those investors are better able to bear risk?

With respect to investors' expertise, somebody with a 401(k) plan, sure, it's retirement money, but they may have long term experience managing that retirement money, and in fact, they may have proven a certain level of sophistication by taking advantage of the tax benefits that you get by putting your money in a retirement account as opposed to an ordinary investment account.

I'm not sure those distinctions really give us a sense that the personal residence or the person with a lot of retirement money should be protected in a different way or is more in need of the sort of maternalistic style of protection than an investor that has their money outside of those kinds of vehicles.

I also think we have to keep in mind that when we talk about protecting investors, it's a two sided coin. On the one hand, we want to make sure that investors don't put their money into investments that are not suitable for them or they become victims of fraud.

On the other hand, we want to give them appropriate access to investment options. That gets me to the issue of motivation for a change in the dollar limits.

If you look through the 2006 release and 2007 release, which I realize are old products, the motivation there talks mostly about the fact that the percentage of the population that qualifies as an accredited investor has gone way up. It was less than two percent in 1982, now it's over eight percent. We are led to believe that is a justification for changing/raising the dollar limits.

First of all, how do we know the levels were right in 1982? We picked a number. It had the benefit of being easy to use and predictable and so forth, but did it really provide the cutoff at the right place in terms of investor sophistication.

Number two and more importantly, the world has changed since 1982. We have the Internet. We have a huge amount of information that's available to every day retail investors that wasn't available then.

Hedge funds, which were the subject of the 2006 rule proposal, have become largely mainstream, there is a lot more information about them, their investment strategies, they are reported by the media, the way they compensate portfolio managers is widely known. That wasn't true in 1982.

We have intermediaries like Morningstar, that provide all sorts of information. Intermediaries that provide information on small companies over the Internet, whereas you used to have to go down and visit a plant to know what was going on. Now you can pull up a lot of information online.

And even for individual investors, their role in managing their investments has changed. Many more investors today have 401(k) plans, have defined contribution plans, in which they are responsible from their 20s in choosing their assets, choosing their investments to some degree, as opposed to the investors who were retiring in 1982 who by and large had defined benefit pension plans and didn't really play that kind of a role.

When you think about what's the justification for change and do we need to protect retail investors, I think you have to take those considerations in mind.

We also have a host of new complex products that ordinary retail investors can invest in independent of Reg D and Rule 506.

When we think about protecting investors, what are their alternatives? This particularly struck me with respect to the 2006 rule proposal, where we seemed to be really worried about hedge funds and the risk they posed to unsophisticated investors.

I was thinking yes, hedge funds do pose some risk, but if you look at the market break, if you look at 2008, which was obviously a devastating year for everyone, hedge funds lost less a percentage of their assets than the S&P 500.

The protected investor who invested in that S&P 500 Index fund lost more money than if they had invested in the hedge fund. We're protecting them by not allowing them to diversify and protect themselves against that down side risk.

Even more strikingly, the investor who invested in the 2010 target fund lost more money than either the investor in the hedge fund or the investor in the S&P 500 Index Funds.

Some of those 2010 target funds lost as much as 41 percent, 41 percent of their assets. Those were people that are supposed to retire next year, not all of them.

If we're worried about investor risk and who can bear the risk, those investors, and you don't have to be an accredited investor, in fact, by regulation, it's a default investment in 401(k) plans for investors.

Similarly, ETFs. You think to yourself okay, if you want to hedge there is a lot of other options, you don't have to invest in a hedge fund, you can buy an ETF. Let me read you a description for a hedging type ETF.

It seeks daily investment returns that correspond to twice the inverse of the daily performance of the NASDAQ 100 Index. That sounds like hedging. Okay, I've got a lot of stock, I'm worried that we are in a double dip recession, the stock market is going to go down, I should buy that thing that does twice the inverse of what the market does, because then I'm going to be hedged. I'm not an accredited investor. I can't buy a hedge fund, so that's my alternative.

The problem is those returns are on a daily basis. Over time, there's no guarantee and in fact, it's quite unlikely that ETF will perform in a way that's opposite to the NASDAQ 100 Index Fund.

Retail investors, very complex products, and we don't have that level of protection. A couple of examples to suggest that if our concern is there are risky or complex products out there or products that are not completely transparent, you know, we're not protecting investors perfectly from them, and I'm not suggesting that we should, but I think the rationale then for limits of $2.5 million in assets to invest and to qualify for general solicitation, I think those limits start to look really high.

I want to say one more word about the dollar limits, and that is I've been focusing on individual investors, but it's interesting to think about the individual investor limits in contrast to the rules that we apply to institutional investors.

The current limit for an accredited investor if you're an institution is $5 million in assets. For some of the proposals, they talk about raising it to $10 million.

Five or ten million for an individual is a lot of wealth. For an institution, not so much, and particularly when we are talking about institutions that in many cases are handling other people's money, institutions that are fiduciaries, such as pension funds, and institutions that may be run by sophisticated advisors, but may be run by retirees from that organization, or politicians, people without any particular expertise.

I think we have seen some examples of the trouble those kinds of institutions can get into with things like the Madoff scandal, where a lot of institutional investors that clearly met the definition of "accredited investor" didn't investigate, delegated that authority to people who weren't necessarily trustworthy and so forth.

I think focusing on the individual as opposed to the institution may be a little bit short sighted.

Finally, I want to turn to the role of intermediaries. One thing that Reg D does right now, particularly with respect to Rule 506 and investors who don't have to meet the definition of "accredited," is it has this idea that somehow a purchaser intermediary and advisor is going to play some sort of helpful role.

I think the ban on general solicitation does the same thing. It says you can go to your regular broker, you can go to somebody with whom you have a relationship, and that person can advise you, but you shouldn't be subject to advertisements on the Internet or communications from people that you don't know.

Unless we take seriously the oversight of these intermediaries, I think we really fall down on the job. Preexisting relationship is an invitation to affinity fraud. We know that can happen.

Some brokers provide terrific advice. Some intermediaries don't provide much advice at all. Brokers are not subject unless they are managing a discretionary account, they're not even subject to a fiduciary duty with respect to the investment information they are providing to these investors.

I think when we think about the ban on general solicitation and re-examining that ban, it actually could push us in the other direction, to the extent that there is information out there in the public domain, it provides some protection against that individualized, that one to one communication that very often leads to excessive reliance or to the potential for fraud.

I will stop there.

MR. LAPORTE: Professor Campbell?

MR. CAMPBELL: I think we were all scared to death of going last. I was thinking I was in before Langevoort on that telephone call, but it looks like Don got in before I did. In fact, it is going to work pretty well, I think, for my comments because the comments of each of my predecessors here are relevant to what I'm about to say.

If I might just say, Bill, you seem to be a very nice guy and not willing to pile on with regard to some relief from the general advertisement prohibition, and I would like to pile on. I think it's an insidious concept and has really been detrimental -- perhaps that's too strong a word -- it is a limiting concept that has been especially detrimental to small capital formation.

I would also like to second Bill's analysis of the Commission looking real hard at Section 28. I think it just gives you guys some flexibility to do some stuff that will not force you into bad policy decisions based upon court decisions that happened in the 1950s.

I pile on with regard to both of those comments that you made. I think they are very much worth serious consideration by the Commission and the staff.

My remarks about accredited investors are going to be made from the point of view of assuming, at least in the beginning, that we are dealing with the concept of an accredited investor in isolation.

That is that we are just making some assumptions that all the rest of the regulations remain the same.

My suggestion to that, if we operate from those assumptions beginning, is that I would disfavor, I would be against any material increase in the natural person criteria which is basically $1 million in net assets, roughly speaking, and $200,000 income. I would oppose any material increase in that.

It seems to me just as an observation that if in fact that threshold were raised, internal consistency and what I would call the Yogi Berra rule, would require 504 and 505 to be raised as well.

The Yogi Berra rule is that a nickel ain't worth a dime any more, and if we are raising the accredited investor in some way to account for inflation since the initial promulgation of it, it seems to me internal consistency would require a good hard look at the 504 and 505 limits as well, because a nickel ain't worth a dime any more on both sides of the equation, it seems to me.

My recommendation that we not in any material way raise the accredited investor criteria, and "natural person" is what I'm really commenting on. I liked Jill's comments about the institutions. That is really another ball game, it seems to me.

My argument in favor of maintaining roughly where we are with the natural person accredited investor criteria is based on the following analysis.

First, and this really gets to both the comments of Don and Jill, I am prepared to accept as a reasonable, and I'll underscore "reasonable," proxy for both access to information and sophistication.

I would accept as a reasonable proxy for those, where we are right now. If you go back to access to information and sort of the history of that concept, and I guess I can call it roughly the jurisprudence in this area, the concept of access to economic bargaining power, and I am prepared as a reasonable proxy to assume people who have these kinds of incomes in most situations are going to have the economic bargaining power to be able to bargain for and extract as a condition of putting up their money if they so choose, that people have access through the sort of traditional economic bargaining power.

Again, and Don, I was interested in your comments. Academics, we are really bad for taking our colleagues' comments and twisting them up, but I think I'm doing okay.

What Don was saying, that maybe we need to think about this in terms of sort of who merits as opposed to actually has the qualifications.

Did I do okay, Don? (Head nod.)

If you have those kinds of criteria, it seems to me that it makes sense to use that as a proxy in those levels.

With regard to sophistication, once again, as a reasonable but imperfect proxy, I am prepared to say that it is reasonable to assume that one who is in those ranges, and this gets back to Langevoort's comments, it seems to me, one, either personally has the sophistication at some level to evaluate that, or and perhaps more importantly, along Don's comments, they have the capability of purchasing that sophistication through a purchaser/advisor, if they so choose.

As a reasonable proxy, I'm pretty happy with where we are. I must tell you that the second part of my analysis and argument in favor of keeping this about where it is at this point, has to do with my assessment that any fault, any failure of the proxy being perfect is more than made up for by the boost of capital formation that will occur if in fact we keep the thresholds about where they are.

Maintaining the thresholds where they are will facilitate small companies -- remember that 506 has no amount limitation criteria either up or down -- it will facilitate the access of small companies to capital.

I have always believed that all of us who write and think about this area have tended to under estimate three points, three factors.

One, the significance of truly small issuer's business to this country, the significance of them to the economic system. Two, the need of these companies, these smaller issuers for external capital, and three, I think we have under estimated the structural and legal impediments that keep them from competing on a level playing field with larger companies.

Gerry, we were talking about this. You made the comment that when we talk about small businesses, we all stumble if someone asks us for a definition.

The Small Business Administration puts out some wonderful numbers, a bit late, but every year, I'm assuming they are still doing this, about small businesses.

They have some absolutely remarkable numbers in those studies. One of the most remarkable numbers to me is this one. Historically, if you go back and look at those figures over a period of time, approximately 20 percent, a little less than 20, about 20 percent of the businesses in this country operate with less than 20 employees.

I said that wrong. Excuse me. Twenty percent of the employment in this country is provided by firms with less than 20 employees. Five million roughly of these companies and they represent 90 percent of the business units in this country. These are very small companies.

My neighborhood restaurant where I think I took Professor Langevoort when he visited me, has more than 20 employees in it. These are very small businesses.

If you go up to 100 or less, 40 percent of all the employment in this country is provided by these companies.

I think it is no surprise to us that these businesses must have external capital in order to be able to compete. The SBA numbers that I get, they tend to look at access to credit, 85 to 90 percent of these companies are seeking external credit capital, if I may use that term.

I think those kinds of numbers do not surprise us at all because very few firms, especially start ups, generate enough internal funds to be able to commence their operations.

Finally, I think we have all under estimated the structural and legal impediments to the operation of capital formation. Structurally, there are two huge matters out there for these companies. One, their capital needs are small. This tends to mean the relative transaction costs, relative to ultimately yield, how much you make, tends to go up high very quickly on these guys. As you all know, it is relative costs, not absolute costs, that kill deals and kill access to the market.

The second issue which is related to this is the limit, at least, on financial intermediation that these companies face. It is very difficult for my neighborhood restaurant to interest Goldman Sachs in helping them raise half a million bucks, to be a bit absurd with this.

The financial intermediation is often not there. These guys are principally in a lot of cases on their own to sell their own securities and the other impediments they have are legal impediments. Here, it is our Federal laws and regulations and our state laws and regulations that take the toll in this.

Certainly, there are policy reasons for why we do this. I think we all agree with them, and I certainly do, but we must be realistic in the fact that bad regulations from the SEC or states can in fact throttle capital formation for these very small companies.

Maintaining access to 506 for these small companies I think is very important. 506 may be a very, very attractive way, and now I'm thinking about capital formation, I'm prepared to accept proxies that are reasonable but not entirely precise, because the tradeoff here in my judgment is capital formation, access to Rule 506, I believe, is important for these small companies.

If small companies make a 506 offering with accredited investors, they pick up some very favorable criteria for them, very favorable rules.

First, for example, there is no mandated disclosure for the predicate to Rule 506, if you're selling to accredited investors in a situation.

We should all keep in mind, and this is again something I think we forget sometimes, is that indeed, there are disclosure requirements in a deal like that.

One source would be the contractual arrangements between the issuer and the investor. Two, Rule 10b-5. Any material omission of fact generates civil liabilities. It's not as though everybody has packed up and gone home on those issues. There are disclosure requirements in the situation.

They are still subject to the limitation on general advertising, which I hope the Commission will at some point take a look at, and I don't know if this slipped through with you guys or not, but roughly a year and a half ago, the Commission amended Rule 144 and Rule 145.

It seems to have been a very quiet process at this point in that people aren't shouting. I'm shouting on that. I think they were wonderful amendments.

Essentially, what Rule 144 does at this point for the kinds of companies I'm talking about means the resales are predicated probably on a one year holding period and that is it, no more broker transaction requirements, whatever, if you're a '34 Act company and up to date on your filings with the Commission, a six month holding period.

These are very important rules with regard to attracting front end capital to these deals.

Maintaining Rule 506 is very attractive at the Federal level. The most important thing perhaps about 506 is that Rule 506 is the only exemption, Federal exemption, broad applicability, that preempts via NSMIA state control over the registration process.

You guys may not know the history of this, but as NSMIA was originally introduced, the preemption was much broader. The preemption was the preemption of all exempt offerings essentially except the intrastate offering.

As the legislative process wound around, the ultimate outcome was the legislation was redrafted and the only exemption now preempted are exemptions in regulations enacted under Section 4(2). That is pretty much it for the broad ones at this point.

What that means is Rules 504, 505 and the dormant but has a wonderful future if people would focus on it, Regulation A, they will be back in the clutches of the states and common law, too, none of those are preempted at this point, and that was changed during the legislative process.

Perhaps one of the most important aspects of keeping 506 reasonably available to small issuers is that if they qualify for 506, they don't have to worry about the state registrations. I'm sure you guys have been involved in this if you have a non-registered offering that involves four or five states, you have five or six regimes you have to comply with. For small offerings, the additional transaction costs are hurtful.

I would argue in favor of access to 506 and I would argue in favor of not materially changing it. We do need to take notice of the fact, and Gerry was kind enough to point this out in our conversation, that Senator Dodd's bill, last week, is that when it was introduced, or it was introduced --

MR. LAPORTE: It's actually just like an exposure draft. It hasn't been introduced. A circulation draft, I think, he called it.

MR. CAMPBELL: In that circulation draft, the one that you sent us and I pulled down, was a modest 1,136 pages long, in that draft, on page 686 of the 1,136 page draft, is a proposal to eliminate the preemption provided by Rule 506, to do that by statute.

Obviously, I think that's a wrong headed way to go on this. I just think that is not good. If you bury in 1,136 pages of a highly, highly contentious piece of legislation, I think the risk is it may just quietly slip through, if in fact that were to come about and be introduced in that way.

There is also an accredited investor provision in there as well that basically commands the Commission to re-evaluate "accredited investor," and they seem to be tying it to my Yogi Berra rule, in light of inflation. There is some inflationary language in there.

I would hope maybe that one provision about 506 would be exorcised from this.

Thank you.

QUESTION AND ANSWER SESSION

MR. LAPORTE: I might just remind the Webcast audience that if anybody wants to submit a question via e-mail, they can send it to Smallbusiness@sec.gov.

Meredith, do you want to ask some questions that have been submitted? Unless other people have questions or some of the commentators want to comment on each other's statements.

MS. CROSS: I thought I would read two that shows the quandry the Commission staff finds itself in. They are great compare and contrast questions. One of them says, does the SEC have data that indicates that current individual accredited investors on the lower end of the accredited qualification have a significantly more adverse experience than individual accredited investors that have more significant assets or income?

If there's no data that differentiates between lesser accredited investors and investors that meet the new thresholds, is this just a regulatory initiative that simply fixes something that isn't broken?

The other question is recent studies indicate that for all fraudulent activities involving securities, the large proportion involves Reg D Rule 506 offerings within this context. Would you propose or continue to espouse new Rule 507 or should you impose more regulatory scrutiny on Rule 506?

We are working on something that doesn't need fixing and then we need to fix this fraud.

I open it up to discussion. I think beyond just the accredited investor question, are these issues that are not problems and they don't need fixing or are these -- I will say on the data front, I don't know the answer to that question. I wasn't working here then, so I can't answer the question of whether we have the data.

I know from when I worked here the first time, that we struggled in trying to identify within the accredited investor community the different thresholds.

I can't answer that question. I am curious to hear the thoughts of the panel on is Reg D overall good policy, does it need fixing, or are we just worrying about this because it sounds wrong?

MR. LANGEVOORT: Let me start, and I want to pick up on what you said. In terms of data, we don't have good data at all about the correlation between different types of Reg D offerings and bad outcomes in terms of investor losses, partly because the Commission has never collected much Reg D data. Form D does not reveal very much at all. Therefore, trying to measure this empirically is quite a challenge.

In addition, you would have to figure out what to correlate it against, investor complaints before FINRA or SEC enforcement actions. I just don't know that that work has been done. It would be fascinating to find out.

It does strike me that at some point in the future, given advances in technology and the ease of filing information today, that collecting more data about Reg D offerings should not impose a significant burden, and should allow the Commission staff to answer these questions rather than just speculating about them.

I'm going to share I think the view of all the panelists, that there is no basis for concluding that Reg D is a failed experiment.

We certainly don't know that it is. I would have to believe that in terms of capital formation effects, as compared against observation of investor losses, making the claim that if we shifted a greater number of offerings into some other world, not registered offerings because they simply will happen, but some other kind of world, that we have significantly less investor loss, I doubt it.

I think it probably has been a successful experiment. The question that the Commission has to ask itself is in terms of whatever reason you'd like to articulate for a test of who can fend for himself or herself, do you have reason to believe that $200,000 or $300,000 joint, and to me the more problematic net asset test is likely to connect to that in any meaningful way.

I have to believe inflation is relevant to that question, and that's why I think unless the 1981 decision to pick those numbers had incredible foresight in terms of where it would put us in 2009, it's hard to believe that necessarily is the right answer.

MS. FISCH: I think it would be tremendously valuable to start collecting this kind of data. To my knowledge, the Commission doesn't have this kind of data. It's certainly not in the documentation that issuers typically file.

It would be really useful to know who are the investors in terms of how they meet the "accredited investor" standard, and it should be feasible to collect information on bad outcomes.

The way Don described it is kind of interesting because what are bad outcomes in evaluating the success of Reg D? Is it cases in which investors are defrauded? Is it cases in which investors lose their money because the business goes under?

One of the reasons that issuers need to resort to Reg D is because they have a need for capital and they are at a tremendously risky stage in their operating life. You get to a point where you have achieved a certain amount of success and maybe a public offering is possible, and at that point, I suspect just the normal correlation between business size and failure, you are less likely to fail.

I would not view it as a deficiency in Reg D that some not trivial number of the companies that do a Reg D offering wind up going bankrupt, wind up failing, and investors wind up losing money. That's not an unanticipated or necessarily a negative outcome associated with the rule.

The securities laws are not set up to protect investors from that contingency.

MR. CAMPBELL: Could I offer just a broader comment on this? I think Reg D is wonderful in its overall structure. That is if you start with 504 and go through 505, what the regulation as a whole does is that it strikes a balance, I think, and this of course is the Commission's obligation now under Section 2(b) of the '33 Act, it strikes a balance between investor protection and capital formation.

When you start with 504, there aren't a lot of investor protection requirements as a predicate for the availability. When you move up to 505, you layer on some new disclosures. You move up to 506, you have your disclosure plus your accredited or sophisticated investor.

Also, the disclosures are more onerous as you get bigger. That's the way that it ought to operate. We may disagree about certain parts of it, but I would strongly urge not giving up on that fundamental construct there. I think it's very good.

MR. SJOSTROM: I just want to comment on the 506 fraud question. I guess my answer to that is of course there's more fraud with respect to 506 offerings because 506 is the most widely used exemption by far. From that perspective, there's going to be more fraud.

The other thing to keep in mind is it's not possible in the tradeoff between investor protection and capital formation to eliminate all fraud. There is some optimal level of fraud in making that tradeoff, and that's what we should try to arrive at.

MR. LAPORTE: On the data question, I'm not sure we are that far from the databases that Meredith remembers that we had ten years ago or so, 12 years ago. We have done something with Form D, obviously, increasing the requirements to file information on Form D is in itself a problem unless as Don said, it's a relatively easy burden to overcome.

We just went through a very intense Form D process where we re-did the Form. The information is starting to come through, that we are now able to evaluate. For one thing, this is just sort of a fact that we never knew before, but now we do know, about 20 percent of the Form D offerings involve the payment of compensation. That is something we always wondered about. My guess is we could have counted them by hand. Now we have an easy way to get that number.

You can interpret that in different ways. You might say oh, my God, only 20 percent involve a professional, and you might say we have to increase that percentage, or you can say isn't this great, these people don't have to pay intermediaries. It just depends on how you want to interpret that.

We also now have a Division of Risk Fin here. We have specialists there who are better, I think, than some of the attorneys in Corp Fin looking at bad outcomes and figuring that out. We have talked to them about perhaps producing more data in this area that might be more reliable.

We do have people on staff that are more used to dealing with statistics than some of the lawyer trained people.

MS. CROSS: I think on the concept of having better visibility into the exempt markets, that would be helpful across the board for what we are trying to do with reg reform. A lot of what we are hearing are questions about what is going on in the exempt world and to the extent that what we want to do is continue to have those markets and have law makers believe that is a responsible thing to do, it would behoove us to get more information.

I think we are looking at ways that we could do that, without imposing terrible burdens. I think those are key points.

One follow up question to what we are talking about. Do you think that the information requirements in Reg D appropriately balance the needs of investors against the burdens on companies? Is a change in the information requirements something that could be considered or you would consider instead of changing the "accredited investor" definition?

For example, you don't have to give any information to accredited investors. Say you are using 10b. 10b is a pretty high standard. You have to show scienter. If somebody makes $250,000 a year and might not be able to demand information, if they were required to be given information, or is that too burdensome for companies?

MR. SJOSTROM: One thing, there is kind of a disconnect between information and sophistication because if we are assuming you're sophisticated, then you will not go forward with an offering unless they provide you with sufficient information so you can make a decision.

I think there is some disconnect there. I don't have a problem with requiring more information -- requiring information be provided to accredited investors because I think in the marketplace, it often times is anyway. The trickier part is I suppose what type of financials you are going to require. That can be a substantial cost for particularly small companies when you have to include audited financials.

More disclosure, generally, I don't see as a big deal. I don't think it's really necessary either. That's really how the market operates as things stand now. Investors demand it and if we're assuming accredited investors are sophisticated, then of course, they demand it.

MS. FISCH: The one place that I think it might be worth thinking about, information disclosure, is with respect to broker intermediaries. Don mentioned looking at selling practices. I wonder if both disclosure and some sort of written record might provide a level of oversight about that role.

I don't know the percentage of broker intermediated transactions that are associated with fraud versus the direct transactions, but that might be a way to get a handle on it, and it would also be useful because the broker often operates as a substitute in terms of assuring the reliability of the transaction. I think broker recommendation might cause the investor not to seek out the information directly.

MR. CAMPBELL: My comment is broad again. I think the way you guys do the step transaction requirements on disclosure is once again right on the mark. We might argue whether or not $2 million is the right threshold, whatever, but I think that is right.

Again, it goes back to the point I made as to what kills deals for small issuers are the relative transaction costs, not the absolute transaction costs. As deals get bigger, they can step up for more costs without destroying their capital formation process.

I think that's good. The other thing I would point out is I think once again Bill identified the big cost, and this is actually accommodated in the way the present reg is written. That is the huge costs are going to be audits, and also the other costs are going to be compliance with S-X, if in fact you have to comply with S-X, your friendly local very capable CPA on the corner can't do it. Your costs are going to drive you into the final fours, that they're called, at this point, and costs go up.

Again, step transactions, more disclosure, as the deal gets bigger, perfectly logical. That's the way you live up to your 2(b) obligation to balance investor protection against capital formation. I think Bill helped you identify what you probably already knew, what the big costs are.

MR. LAPORTE: There is one school of thought that most of the really problematic offerings under Rule 506 really don't involve business information as much as conflicts of interest and things like that. If you could say you have to have disclosure about these types of things, if you have conflicts of interest or payments to promoters and things like that, even for deals in which it's all accredited investors, that would help to the extent that these offerings are problematic.

MS. CROSS: I think we are coming to a close here. I want to give everybody an opportunity if they have other things they want to address.

Commissioner Paredes? No. Okay. I think we can take our lunch break. Thank you.

(Applause.)

(Whereupon, at 12:37 p.m., the panel discussions were concluded.)