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Hearing on:

"The SEC's Role in Capital Formation"

Testimony By:

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The Need For Oversight of SEC Capital Formation Rulemaking

There is nothing more important to the economic prosperity of the United States than capital formation. It is the engine that feeds the creation of jobs, supplies earners with additional income and accumulates savings for retirement, which provide for the security of the overwhelming number of Americans. Yet, the government agency most responsible for overseeing the capital markets—the federal Securities and Exchange Commission (SEC)--does not take seriously into account the effects of its rulemaking on capital formation when it exercises its powers of regulation. This is a public scandal.

Congress long has been aware of this problem. In 1996, the forerunner to this committee initiated and passed the National Securities Market Improvement Act (NSMIA) that specifically required:

> Whenever pursuant to this title the Commission [SEC] is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[1]

Yet, as this committee has found in the past, the SEC has ignored this provision. On April 17, 2000, both former chairman Tom Bliley and current chairman Michael G. Oxley wrote to then SEC chairman Arthur Levitt an oversight letter requesting information inquiring whether the SEC had followed this section of the law.[2] After receiving the Levitt and staff SEC response in a May 24, 2000 letter, and reviewing it, both the past and current chairman wrote again. This time they concluded that the current SEC practice "does not meet that [NSMIA] standard".[3] Reading the SEC response, one is forced to agree.[4]

Committee Chairman Michael Oxley and Subcommittee Chairman Sue Kelly are to be congratulated for pursuing this critical matter now with a Congressional oversight hearing. The easy way to make headlines is to focus exclusively upon fraud. And, certainly, the prevention and punishment of fraud are important functions. Yet, as will be demonstrated below, the SEC attacks fraud in its rulemaking by "correcting" unrelated, more substantive rules and leaving the fraud rules unchanged, a logical non-sequitur. It has used capital formation rulemaking as a means "to do something" to meet Congressional and investor concerns, without any real effect on the definition or enforcement of fraud. Its only remedy is to increase "disclosure," regardless of cost. As Congress recognized in 1996, this does not make sense. In addition to the important duty of protecting investors, the SEC must also consider efficiency, competition and capital formation if it is to regulate in the full public interest. The most serious example of this mode of thinking occurred in 1999 when the SEC effectively eliminated its most important capital-generating initiative, evaluating capital effects, efficiency and competition only in the most superficial manner in its final decision. Apparently, passing the law and a formal committee finding are not enough to get the attention of the SEC.

This is no academic exercise. At the very time the committee was seeking compliance with the law by the SEC, that agency was pursuing perhaps the most destructive action of its long tenure—eliminating public securities offerings from coverage under Rule 504. The original rule may have had as much effect in creating the nearly two decade boom starting in the early nineteen eighties as any of its more heralded contributing factors. Yet, in 1999, the SEC eliminated this source of capital for small public offerings and within a few months the small capital markets stalled and, later, tanked. It is enormously important that this Committee investigate what happened at that time when the SEC ignored the law--and the committee's warning--so that this destructive economic dislocation never is caused by the government again.

Small Business Is The Prime American Capital Generator

The capital markets for large private sector corporations in the United States are the most efficient imaginable. A public firm that can be listed on the New York Stock Exchange can raise the funds it needs, whatever the level, as long as it can convince investors that its future will be as successful as the present or even better. The secret is their large resources base and current success, reflected in the fact that it qualifies for listing. The same may

[1] National Securities Markets Improvement Act (NSMIA) of 1996, Section 3(f) of the Securities Act and corresponding provisions of the Exchange Act and the Investment Company Act.
[2] House Committee on Commerce Correspondence, April 17, 2000, number 7.
[3] House Committee on Commerce Correspondence, August 2, 2000, p. 2.
[4] House Committee on Commerce Correspondence file, SEC Memorandum dated May 24, 2000, number 7, p.7.

be said of the NASDAQ national and small capital markets. The situation is not as favorable for the millions of small firms that are forced to rely upon the NASDAQ Over The Counter (OTC) Bulletin Board, the private National Quotation Bureau's "pink sheet" markets, or private funds raised from friends, relatives and neighbors.

While small business has the most difficulty in raising capital, it is clear that small business also is the most dynamic part of the business market. It creates the overwhelming number of new jobs and it is the source of much of the innovation that makes the U.S. business sector so dynamic. As shown in Table 1, a bit more than half of all employees work for firms with fewer than 500 employees. Equally important, these firms produce 47 percent,

Table 1. Importance of Small Business

Firm Size	Employees (1995)	Receipts (1995)	Net New Jobs (1992-1996)
Under 500 employees	52,653,000	$ 7.4 billion	11,827,000
Over 500 employees	47,662,000	$ 8.3 billion	- 645,000

Source: Small Business Administration, Small Business Answer Card, 1998, pp. 1,3.

or almost half, of the business receipts of all firms. The most interesting statistic, however, is their affect on new job growth. As noted, firms of over 500 employees actually had a net decrease in jobs over the period of 1992 to 1996. If all of America were large firms, employment would look like that of Europe, stagnant. But the greater number of small firms in the U.S. has been the source of its greater dynamism. Firms of under 500 employees have created all of the net new jobs during the boom years. Indeed, most of the jobs were created by firms of five or fewer employees.

Surprisingly, most of the funds are raised privately from friends or on private credit sources.[5] About 75 percent of small firms seek credit, mostly from traditional or commercial loans or from personal or business credit cards.[6] But those firms that wish to grow more substantially generally must ultimately raise funds publicly. It is just not possible to grow very large without raising funds in the securities markets. And there one comes into contact with the government regulation of securities and exchanges.

The Securities and Exchange Commission Regulatory Structure

Securities have been regulated in the United States since 1933. The Securities Act of that year required that companies give investors "full disclosure" of all "material facts" that investors would need to make an investment decision, to register investor information with the SEC, which declares the investment "effective" (but not safe or good) if they satisfy its disclosure rules. The Exchange Act of 1934 required public companies to disclose information about their business operations, financial activities and management to the SEC and, in some cases, to investors.[7] Over the years, filing and information production requirements have grown more complex and more expensive. It is virtually impossible for the average small businessman to keep up with requirements. Indeed, the SEC itself recommends the use of an attorney to avoid possible penalties.[8]

In an effort to help small businesses without great staff support, the SEC opened a Small Business Office in 1979 to provide assistance.[9] Yet, it was forced to deal with the existing, complex process and could only assist at the margins. By then, the basic filing form had become very complex indeed. Basic Form S-1 became infamous for its difficulty, cost and density--frustrating the openness originally sought by the acts. A form SB-1 was added to allow transaction under $10 million by small (less than $25 million in revenues and stock worth no more than $25 million) firms in a simpler question and answer format. SB-2 followed for any size transaction with specific criteria in plain language to be followed. They helped a bit but still require professional assistance. Other forms were equally complex. The lack of clear guidance causes innocent error that can lead to administrative or legal problems.[10]

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[5] Steven Moore and John Silvia, "The ABCs of the Capital Gains Tax," Cato Policy Analysis, October 4, 1995, pp. 29-30.
[6] "Small Business Answer Card, " Small Business Administration, 1998, p.1; FAQ Card 2001, p. 2.
[7] "Small Business and the SEC," Securities and Exchange Commission, 2000, pp. 1-2
[8] Ibid., p. 2.
[9] Testimony of Brian Lane, Director of Corporate Finance, before the Subcommittee on Government Programs, House Committee on Small Business, October 14, 1999, p. 1.
[10] "Small Business and the SEC," pp. 5-6.

In response to public and business complaints, both the SEC and Congress have, over the years, provided some exemptions from the more onerous requirements, although even these are properly subject to the anti-fraud provisions of the law. There is an interstate exemption for transactions within a state (Section 3(a)(11)), although it is almost impossible to meet since if even one share is offered or resold out-of-state the exemption can be lost. Private offerings are exempted under Section 4(2) but the purchaser must be a "sophisticated investor" and no advertising or public solicitation may be used. Significantly, even the SEC admits that the precise limits of a non-public offering are "uncertain." Section 3(b) authorized the SEC to exempt small securities offerings and this led to a Regulation A affecting offerings of $5 million or less in a 12-month period. These do not need to be audited. Still, the company must file an offering statement with the SEC for review and a statement similar to the traditional prospectus must be given to investors.[11] The review process is long--often several months, during which time conditions change--and expensive with lawyers, accountants, consultants and the rest.

Regulation D offers some other alternatives. Its Rule 505 offers an exemption for offers and sales up to $5 million in 12 months to any number of investors--but they must be "accredited" (except for 35 other persons), i.e. sophisticated and registered, and the instruments are "restricted, i.e. they " cannot be resold for at least a year without registration. Financial statements must be made available and certified. Rule 506 is a "safe harbor" for the private offering exemption. It at least provides some protection from arbitrary prosecution by spelling out (to some degree) what information is needed (although the SEC will not give absolute assurance against future prosecution).. There is also a general accredited investor exemption (Section 4(6)), for sales for employee benefits (Rule 701), and qualified purchasers in California (Rule 1001).[12] But the only generally useful exemption was Rule 504.

<u>The Reagan Small Public Company Reforms of Rule 504</u>

Inspired by the overwhelming victory of President Ronald Reagan in 1980 and the renewed interest in entrepreneurship and growth this generated around the world, the SEC adopted a major capital formation reform on April 15, 1982. Rule 504 was specifically adopted to allow small businesses to more easily raise capital without the red tape and cost usually associated with SEC offering rules. Small business was recognized as the growth-generator and the need to liberate it from excessive red tape seemed manifest.

Rule 504 allowed private and public stock offerings of up to $500,000 (later raised to $1 million) to be sold within 12 months to an unlimited number of investors without a prospectus and without regard for the investors' "sophistication," accreditation, or amount of knowledge, as long as the offering was filed under state law. These so-called blue sky laws generally required a disclosure document but with less information and fewer costly administrative hurdles.[13] Approval was possible within 30 days (rather than months) by most states at a modest cost. Section 504 immediately became the offering tool of choice among small public and private stock offerings. It unquestionably, became one of the engines for the growth of the stock market, especially, internet and technology stocks and the prosperity that they inspired and led.

Rule 504 was further liberalized in July of 1992. All federal restrictions other than fraud were removed and all offerings under the rule offerings were subject only to state regulations. General solicitations and advertising were allowed and offerings were not "restricted" for resale by non-affiliates of the issuer.[14] Whatever slowdown there was in 1991 quickly turned to furious growth, especially in the small public company area that relied upon these 504 liberalizations to raise the capital necessary for their growth and that of the economy generally.

<u>The Penny Stock Reform Act of 1990</u>

Beginning in 1988, Congress began hearings into complaints of fraud and abuse in the "penny" or "pink sheet" or "gray market" organized by the private National Quotation Board. These resulted in a 1988 law that generally defined penny stock and required additional disclosures. Later SEC rules defined "penny" stock as a security that sold for less than $5 per share and was not listed or authorized for quotation on a NASDAQ market exchange. A risk disclosure document, a disclosure of bid-offer quotations, the compensation of the broker-dealer and a monthly value of stock held were required from broker-dealers, although certain securities were exempted.

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[11] <u>Ibid</u>., pp. 10-12.
[12] <u>Ibid</u>., pp. 10-15.
[13] Final Rule, 17 CFR 230, Revision of Rule 504, 2/26/99, p. 6.
[14] <u>Ibid</u>., p. 7.

Two things were clear from the 1990 hearings and findings: Rule 504 offerings were not implicated and only disclosure rather than changes in the fraud rules themselves was offered as the solution. Indeed, the major study of the changes by two professors from the University of California concluded: "While apparently significant, these rules added little to existing SEC and NASDAQ rules and practices designed to prevent securities fraud in the penny stock market."[15] As a matter of fact, the basic SEC fraud and abuse rules have remained rather constant since the original securities act. They are sufficient to the task of fraud prosecution, as SEC enforcement actions testify.

<u>The Concern With "Microcap" Fraud</u>

No good deed goes unpunished and deregulation of the small capital market was no exception. While recognizing that the Rule 504 reforms generally operated effectively and fairly, but with the large growth in these markets, the SEC, with only spotty anecdotal evidence, began in 1997 to be concerned with exploitation of the Rule 504 exemption. In a few cases, the lack of state regulation in New York was used by dealers resident there to avoid any regulation at all. In some cases, securities were placed with dealers who used cold-calling to sell securities at ever-increasing prices to unknowing investors. Worse, when the inventory of shares was exhausted, the principals sometimes allowed the artificial demand to collapse, selling short or taking paper loses to offset gains, with investors losing their investment, in a scheme called "pump and dump." The SEC initially believed that the fraud was limited to sales in the secondary, i.e. resale, market.[16]

The SEC originally proposed to close the New York "loophole" and to restrict all re-sales for a period of one year. Objections from dealers and others, however, led it to do the former but instead of the latter limited Rule 504 to private offerings only--which it claimed were the vast majority of 504 transactions anyway--plus state regulation.[17] But this left public offerings without the 504 flexibilities and this low-cost means to raise capital. On top of this, NASD, which also has regulatory authority, ruled--with SEC approval--that only SEC-reporting companies could now have access to its exchanges, including the OTC Bulletin Board.[18] The OTC was used by many of the small public companies utilizing 504 without having to report to the SEC. At the same time, NASDAQ and the other exchanges raised the standards for registering with each of the hierarchy of exchanges. In addition, the SEC was considering a rule to require not only the market-maker to do due diligence on a stock offering but for all additional sellers to do so too. Objections from brokers and SEC commissioner Norman Johnson have held up this regulation but it still causes concern in unsettling markets nonetheless.[19]

The requirements for listing were increased substantially. Small firms do not come close to qualifying for The New York Stock Exchange so their only real choices are NASDAQ or OTC. The requirements for their major markets are listed in Table 2. The assets required for initial listing are substantial and, for continued listing, they are even higher. More importantly, the income requirements were raised substantially from the old listing before the regulatory change to the new ones that now apply. For the NASDAQ National Market, the asset requirement was increased 50 percent. The newer SmallCap Market began at the old National level and almost doubled the net revenue requirements. These higher requirements (and the SEC approval processing) caused the greatest burden and the requirements still provide a barrier to entry today.

Table2. Requirements for Access to Capital Market Exchanges (initial listing, pre and post "reform")

	Assets	Float Value	Income/Revenue
NASDAQ National Market, old	$4million	$1 million	$400,000 (net)
, new	$6 million	$8 million	$75 million
NASDAQ SmallCap Market, old	$4 million	$1 million	$400,000 (net)
, new	$4 million	$5 million	$750,000 (net)

Source: The Nasdaq Stock Market, Inc. Listing Qualifications (undated).

[15] Jonathan H. Sive and Michael D. Ames, "How to Narrow the Small Business Equity Capital Gap," Small Business Institute Directors' Association Meeting (San Diego: February, 1996), p. 7.
[16] <u>Final Rule</u>., p. 7.
[17] <u>Ibid</u>., pp. 8-9.
[18] "NASD Requests Comments on Limiting Quotations On the OTC Bulletin Board To Securities of Reporting Issuers, OTC Bulletin Board News Release, March 20, 1998; "NASD Announces SEC Approval of OTC Bulletin Board Eligibility Rule, " OTC Bulletin Board News Release, January 6, 1999.
[19] Judith Burns "SEC Push to Combat Microcap Stock Fraud Hits Roadblock," <u>Dow Jones Business News</u>, 9/13/99.

The SEC Cost and Regulatory Analysis in Final Rule 504

The Final Rule Cost-Benefit section does state that the SEC has concluded that its amendments to Rule 504 "will not result in significant adverse effects on efficiency, competition or capital formation." However, as the Committee noted previously the SEC relied mostly on outside sources for data.[20] It justified the absence of data in its analysis by noting that no outside source "had provided data on the plan we adopt today."[21] Since no one knew what plan would be adopted (specifically, excluding public offerings), it did not explain how anyone could have done so. The SEC simply asserted that "those who rely upon the rule will not have significantly increased costs," without data and, more importantly, altogether ignoring the fact that the largest effect was to deny reliance upon the rule for all public offerings. Even for private offerings, it admitted they will be "affected" but did not estimate the costs.[22]

The only specific cost mentioned by the SEC was an estimated $30,000 for preparing and filing Form U-7. GAO reported a NASDAQ estimate of the following fees for an initial public offering of $25 million: SEC registration $9,914, NASD filing fee $3,375, NASDAQ entry listing fees $63,725, NASDAQ annual fees $11,960 and state filing fees $15,000; or $104,024--perhaps close enough for government work. Yet, the SEC itself recommends using lawyers and accountants, which cost the following: accounting fees and expenses $160,000, legal fees and expenses $200,000, and transfer agent and registrar fees $5,000; or $365,000 more. In other words, a potential expense up to $439,000 (although not all would apply at this level in every case) was not considered--and this did not include the largest expense, the underwriting fee of $1.7 million, to say nothing of the loss of a capital market altogether.[23]

The SEC rule is most disingenuous in stating that, "Overall, the rule will maintain the benefits that allow small companies to raise 'seed capital' with a minimal federal compliance scheme for public offerings."[24] Since the new rule eliminated public offerings from Rule 504 coverage altogether, this is a very misleading statement. Together with the OTC requirement to register with the SEC (much more expensive than with the states)--which the SEC had just approved one month before this Rule--it is profoundly misleading indeed. It may rest on the meaning of "federal," by excluding the OTC requirements. It is difficult to believe such an artful statement by a private securities firm would not be considered fraudulent by the SEC enforcement division.

Given the cavalier manner in which this cost-benefit analysis was performed, it is not unreasonable to conclude that the SEC, in fact, ignored the NSMIA requirements. At the least, the costs and economic effects were grossly underestimated and the major change of eliminating public 504 capital formation offerings was simply ignored.

The SEC Kills the Boom

The result of these changes was that efficient, low cost, public Rule 504 capital offerings were denied to all companies and 2,982 firms were thrown off the OTC Bulletin Board into the more turbulent pink sheet market or worse, into bankruptcy.[25] This pink sheet market is the same one that during the penny stock scandal was reputed to have a fraud rate of 20 percent.[26] This rash action was taken even as the SEC acknowledged that the original "scope of the abuse is small" even in the 504 secondary market.[27] *In other words, the SEC remedy was to throw the overwhelming number of firms that were not engaging in fraud into a less regulated market where they were more subject to fraud.* It is understandable that the private OTCBB would desire to have its own market as free from abuse as possible and to wantonly cast out the good (but poorly capitalized) firms with the bad. The supposed rationale for the very existence of the SEC, however, is to look at the larger public good and be concerned with all firms, perhaps especially the weaker companies (but ones with future potential).

The SEC even made matters worse. The OTC required that any firm desiring to be listed by it had to first be a reporting firm with the SEC. But the SEC, by law, must approve OTC actions. *At the very least, the SEC--on*

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[20] House Commerce Committee Correspondence, August 2, 2000
[21] Final Rule, p. 9
[22] Ibid.
[23] "Small Business Efforts to Facilitate Equity Capital Formation," Report to Chairman, Committee on Small Business, U.S. Senate, (Washington, D.C. : General Accounting Office, September 2000), p. 23
[24] Final Rule, p. 10.
[25] "Eligibility Rule Phase-in Complete," OTC Bulletin Board News Release, June 28, 2000.
[26] Sive and Ames, p. 6.
[27] Proposed Rule 17 CFR 230, 5/21/98, p.2.

efficiency grounds--should have revised the OTC rule to allow time for the early-reporting firms to prepare for reporting, or limited the Form 10 requirements its staff could impose, or delayed the OTC rule until the SEC itself would have been able to process the new application on a timely basis. The listing requirement by a date certain and the necessity for SEC approval was the main reason small public firms were forced off the OTC Bulletin Board market. Many could not meet the high costs for qualifying for reporting status even though they were solvent; but the real problem was, with the large number of companies required to file, the SEC approval process choked from the new paperwork and new requirements imposed by staff. So, even firms that could comply were delayed. In the raucous chase for capital, time is essential and many firms were driven out of business when they could not raise timely capital because they still had not received SEC approval. This created a liquidity crisis that pushed many into insolvency.

Figure 1 shows that the stock market boomed after the SEC adopted the original Rule 504. Market analyst Laurence Kudlow (while making an unrelated point) places the time of the fall of the NASDAQ high tech market as March 2000.[28] Figure 2 documents the disruptive effect of the SEC Rule 504 and OTC decisions on the small cap market. Before the SEC action, the market remained upon its upward course. Following the April 7, 1999 effective date for the amended Rule 504, the small cap market dropped like a stone. For the one-year plus period of the SEC-OTC eligibility process, the market was remarkably unstable. After OTC closed its eligibility process on June 28, 2000, the small cap market dropped even more precipitously. *These data are a remarkable confirmation of the negative effects of the SEC rulemaking on small firm capital formation.*

The OTC data are also illuminating. As Figure 3 shows, the number of positions (priced or unpriced quotes by a specific market maker in a specific OTCBB security) peaked in 1999 before the registration fiasco. The number of deals rather than the total dollar amount is the more important data for small firms that place small dollar offerings. They do not show up in the big dollar totals. As shown, the year 2000 had fewer offerings than either 1999 or 1998. The 1999 high was not reached again until April 2001 and the small public capital markets have still not fully recovered today. The year 2000 dollar NASDAQ Small Cap volume was less than half what it was the year 1999 and the 2001 figures are still well below the high.[29]

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<u>Why Were Capital Markets Harmed By the SEC?</u>

It is clear that the SEC views itself exclusively as a fraud cop. That is why Congress was forced to pass a law that required it also to consider other major factors. All of SECs publications and its web site emphasize its single-minded role in protecting the investor. Clearly, this is a very important function. But its powers—even before NSMIA—went well beyond fraud protection. It has regulated securities and exchanges in a myriad of ways. Yet, its only self-perceived function other than direct regulation of fraud through warnings and enforcement has been to provide information to protect investors from future fraud--providing "transparency" through disclosure. But these decisions affect capital formation, efficiency and competitiveness. The Committee correctly concluded that the SEC had been insensitive to the costs it imposed through it disclosure and other requirements. That is why the Committee sponsored the NSMIA requirements to also consider efficiency, competition and capital formation. For some reason, probably bureaucratic resistance to new ideas, the SEC has been unable to adjust to the law. It continues to focus exclusively on fraud prevention and provides superficial cost benefit analysis at best.

SEC's focus upon fraud is so narrow that it leads to misunderstanding fraud itself. The 504 rule change was no exception. The SEC Proposed Rule reported that "initial Rule 504 sales have not necessarily been fraudulent." Still, it was concerned that the rule's "flexibility" could lead to abuse in subsequent (secondary market) sales. Yet, by the Final Rule, the SEC had discovered "recent disturbing developments in the secondary markets and, to a lesser degree, in the initial Rule 504 issuances themselves."[30] It then mentioned three examples of the types of fraud perpetrated--making offerings in states without registration, broker cold-calling, and pump and dump market manipulation.

The SECs illogic is mind-numbing. First, the SEC itself says: "Rule 504 is the limited offering exemption."[31] That is, secondary sales are <u>not</u> 504 sales by its own definition. So, the remedy to the "major degree" problem should not be to Rule 504 at all but to secondary market rules, which the SEC <u>declined</u> to modify in the

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[28] Lawrence Kudlow, "Supercharged Signals," <u>The Washington Times</u>, June 17, 2001, p.
[29] NASDAQ Market Data, nasdaq.com.
[30] Final Rule, p. 3.
[31] <u>Ibid</u>., p. 2

final rule.[32] Second, as far as the newly-discovered allegation of a "lesser degree" problem in initial offerings, it is unlikely they exist at all, even under SEC's narrow view. The two cases cited by the SEC in the Final Rule do not, in fact, make the case. The Millennium Software case involved a private offering, not a public offering that was eliminated by the SEC rule—the case is about fraud, pure and simple and not about any Rule 504 provisions. [33] The Spacedev/Benson case involved false and misleading statements in press releases, a newsletter and the Internet—again, nothing to do with Rule 504 exemptions per se.[34]

Third, the problem that some states did not have any regulations was solved by requiring them to have them—but, again, this had nothing to do with Rule 504 itself but only closed a state loophole. While state rules varied widely, most had reasonable disclosure. Fourth, The cold-calling and pump-and-dump examples were the same ones used to justify the penny stock regulations; but we must concur with the University of California professors that the basic fraud rules were sufficient and did not require change to solve these problems. Enforcement, not rules changes, is the reasonable remedy. Finally, the SEC solution was to deny use of 504 for all public offerings. What does this remedy have to do with the purported problem? In sum, the SEC attacked a general fraud problem for which it has had regulatory authority for generations by eliminating an investment method that had benefited small public companies and the economy generally without considering those effects at all in the Final Rule!

It is this SEC culture of myopic focus upon fraud alone that led to the NSMIA reforms adopted by this Committee. It is hard to fathom that the Final Rule change for Rule 504 was published TWO DAYS after the chairman of the predecessor committee reminded the SEC that it should consider the NSMIA changes in any rules it adopted, and that oversight hearings would be held "to ensure that final rules are consistent" with it.[35] It is essential for the sake of logic and economic rationality that the SEC be required to take a broader view of what it does in a rulemaking process that so greatly affects how markets perform. It also happens to be the law.

Reforming the SEC: What Needs To Be Done

There is no question that many good companies were harmed by the SEC rulemaking and implementation and by the related OTCBB requirements. Yet, there is still broad public support for access to capital for small public companies. Small public companies are the future giants that produce new jobs and wealth. There is a serious question whether giants like Microsoft or Home Depot, both of which started as private and then moved to small public company status, could have sold their second or third products or opened their second stores without access to the OTC Bulletin Board Small Cap exchange. Under today's requirements, they would have not met the minimal levels and could have failed, with all of the loss of wealth, service and jobs that would have entailed. Some future producer of wealth and jobs will be deterred by these higher requirements.[36]

The whole idea of chasing the small public companies off the OTC exchange for not meeting arbitrary filing requirements must be questioned. The SEC itself recognized that only a few bad apples were causing the fraud. Yet, 3,000 firms were destroyed and many more harmed in the attempt to get a few. The pink sheet market is just too difficult for any but the most sophisticated to utilize. Anyone truly concerned about fraud would not force a single firm into the gray market, much less three thousand. The small public companies that previously had access to Rule 504 need some relief. The answer is to return to the Reagan reforms in a manner that will also minimize fraud.

This is what needs to be done:

1) Make the SEC Obey the Law: Consider Efficiency, Competitiveness and Capital Formation. This committee is to be congratulated for creating a well-rounded agenda for the SEC with the 1996 NSMIA reforms. It is clear from the SEC response of May 24, 2000 to the predecessor committee and its actions in amending Rule 504 that it either does not or cannot understand its new mission under the law. The 1996 act is not even mentioned as a legal authority for the SEC divisions on its web site. Congress must make the SEC follow the law. The future health of essential capital markets demands it.

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[32] Ibid., p. 6.
[33] SEC v Millennium Software Solutions and Mark Shkolir 97 civ. 9019 S.D.N.Y..
[34] SEC Administrative Hearings Against Spacedev, Inc. and James W. Benson, File No. 3-9668, settlement and cease and desist order, August 6, 1998.
[35] House Committee on Commerce Oversight Plan, February 17, 1999.
[36] Barry Henderson, "A microcap fund thrives by focusing on companies with strong managers," Barron's, 4/3/00, p. F8.

2) Make the SEC Recognize that Disclosure Has Costs. At some point, paper disclosure requirements have rapidly demising returns. Disclosure, in any event, does not equal fraud reduction. Fraud is a long-established legal norm at the SEC and can be fully prosecuted under present law. Using examples of pump and dump and cold calling to require burdensome disclosure requirements is not a logical relation of means to ends. All the disclosure requirements in the world will not stop determined crooks. These acts are already forbidden and predators will not be stopped by a few more barriers. As far as can be ascertained, there were no cases of fraud directly related to the Rule 504 exclusions from SEC requirements, in any event. State regulation and general SEC fraud protection seemed to be sufficient and, in fact, were working to create enormous wealth before the SEC eliminated them and disrupted the market.

3) Apply NSMIA to SEC Approvals of NASDAQ and OTC Regulatory Approvals. The facts of the 504 changes reported here make it clear that SEC approval of private market regulations is as important as SEC rules themselves. The new NASDAQ standards for access to the various exchanges were set arbitrarily, and high. The OTC process eliminated 3,000 firms, one or more of which might have survived to fuel a future recovery and create new jobs. Congress should review these requirements and require the SEC to consider the NSMIA criteria in approving private exchange rules too.

4) Give Stockholders More Control of Fraud. The real way to control pump and dump fraud is to require that existing stockholders approve issuance of stock, for they have the necessary interest not to dilute its value. The worst fraud occurs when an owner and small board of directors dilutes the stock while protecting themselves or even gaining in the transaction. The solution is to put stockholders in charge, not remote bureaucrats. Any board or chief executive decision that would have the affect of diluting outstanding stock by 20 percent or more, or equaled 10 percent of a public float, should require stockholder notice and approval. Stockholders should be in control of their firms in any event.

5) Create a New Rule 504 for Public Offerings for Small Business and Raise Transaction Level to $5 Million. Since all small businesses that have survived the SEC transition and now report, all existing small caps already have the higher standards requested by the regulators. All that must be accomplished now to restore the Reagan reforms is to allow small public companies to raise funds within 12 months from an unlimited number of investors, without a prospectus, and without regard to the investors' sophistication (or, at a minimum, at least substantially expand the number of accredited investors). Small public companies need the flexibilities and lower costs of 504 exclusions from excessive reporting--and there are no examples raised by the SEC of abuses that relate directly to Rule 504 initial offerings. The amount of allowable transactions, however, should be raised to $5 million in any one year for all 504 firms, reflecting this good experience and the possibility to increase capital formation enough to restore the earlier prosperity.

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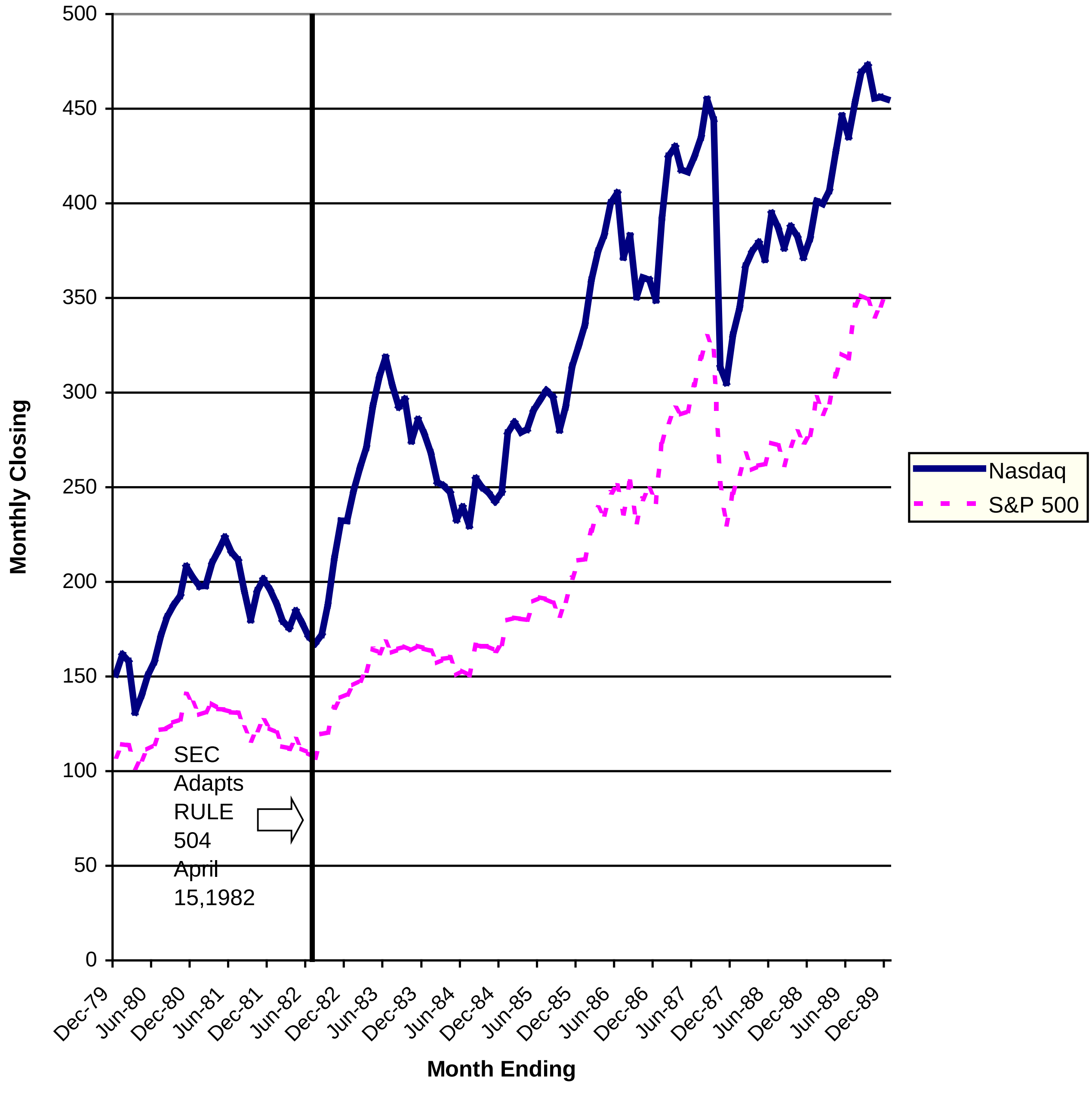
FIGURE 1

Nasdaq Composite and S&P 500

1979-1989



Sources:Nasdaq and Standards and Poors

FIGURE 2

Small Cap Price Per Share 1998-2001

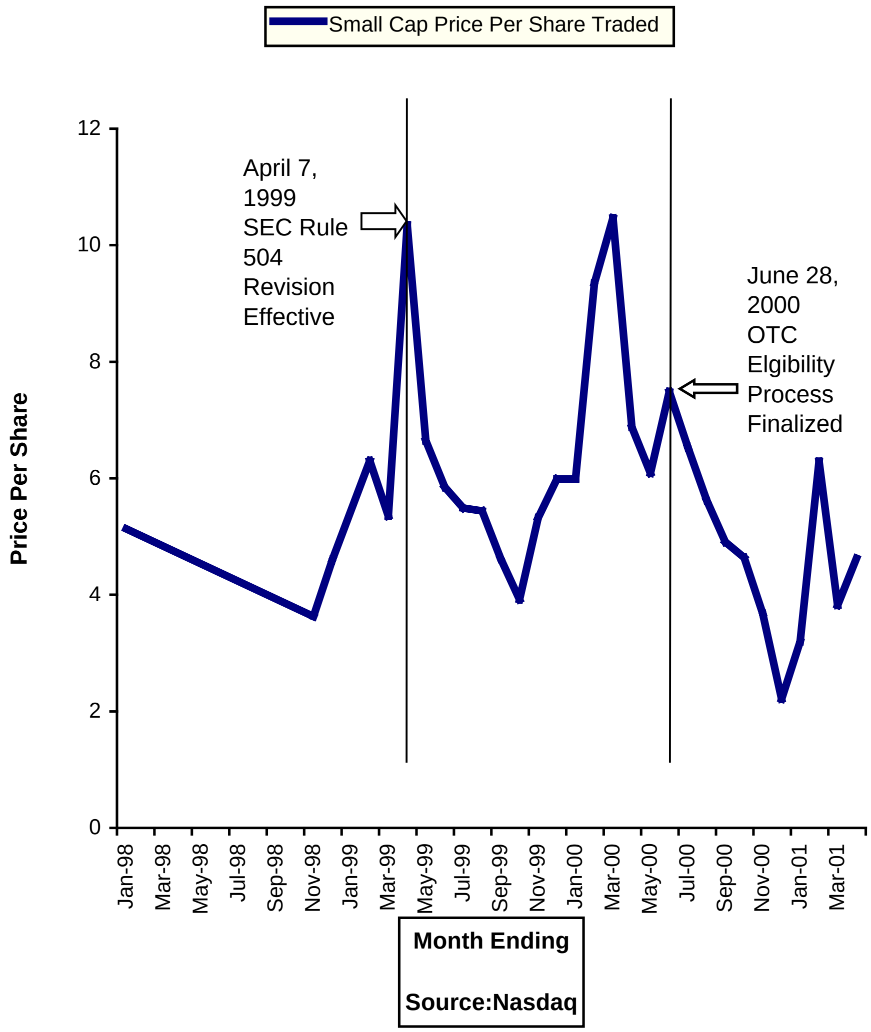
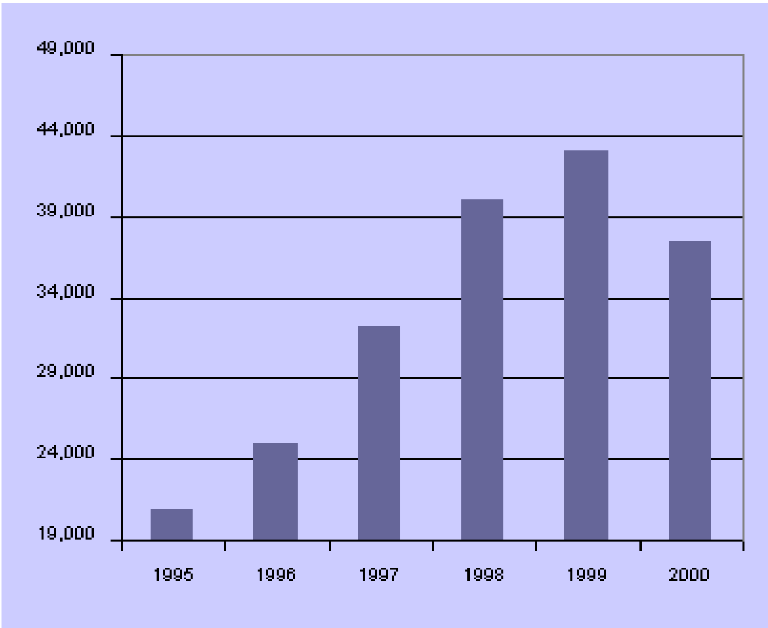


FIGURE 3

Number of OTC Positions

Priced or unpriced quotes by a specific market maker in a specific OTCBB security



Source:OTCBB