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LEGISLATIVE PROPOSALS TO IMPROVE THE U.S. CAPITAL MARKETS

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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LEGISLATIVE PROPOSALS TO IMPROVE THE U.S. CAPITAL MARKETS

Wednesday, December 2, 2015

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:06 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Hurt, Huizenga, Duffy, Stivers, Fincher, Ross, Wagner, Messer, Schweikert, Poliquin, Hill; Maloney, Sherman, Hinojosa, Himes, Ellison, Carney, Sewell, and Murphy.

Ex officio present: Representative Hensarling.

Also present: Representatives Green and Sinema.

Chairman GARRETT. Good morning. And we are not going to go by the clock on the wall, which I see is a little bit behind.

The Subcommittee on Capital Markets and Government Sponsored Enterprises is hereby called to order. And without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Also, without objection, members of the full Financial Services Committee who are not members of the Subcommittee on Capital Markets and Government Sponsored Enterprises shall be permitted to participate in today's hearing.

Now, as we indicated on the website, today's hearing is entitled, "Legislative Proposals to Improve the U.S. Capital Markets." With that, I welcome our witnesses to the hearing today. Some of them are familiar faces and there are new faces as well.

I thank you all for coming and I thank you for appearing before us.

Before we get to the panel, however, I will recognize myself for 2½ minutes for an opening statement.

So today's hearing, as I said, will examine a generalized topic, and in so doing we will be looking at five legislative proposals. And in so doing we will be continuing our work over the last 5 years to modernize those securities laws and help to improve the U.S. capital markets.

Now, four of these bills would build upon the success, if you will, of the 2012 JOBS Act by lowering barriers to capital formation for small and growing businesses. And I want to take this time to

thank the sponsors on both sides of the aisle for their work on those issues.

The fifth bill we will discuss today is one that I have introduced and that is H.R. 3798, the Due Process Restoration Act. This legislation would allow defendants in litigated SEC enforcement cases to have their cases be removed to a Federal district court, thereby availing themselves of the due process protections that currently do not exist in the SEC administrative proceedings.

And you may ask, why is this necessary? Well, in recent years the SEC has transformed itself into a veritable judge, jury, and executioner as it has brought more and more enforcement cases before its own in-house tribunal where they are heard then by administrative law judges who are themselves actually employees of the SEC.

Let us look at the numbers. In fact, in Fiscal Year 2014 the SEC brought nearly half of its litigated actions through administrative proceedings, and that was an increase of about 35 percent over 2012. And its win rate in these cases is, not surprisingly, extraordinarily high.

So while prosecuting more cases in this manner is maybe more efficient and leads to lower expenditures for the SEC, we must realize that these efforts come with a significant cost. The cost is less due process protection for defendants who find themselves beholden to a seriously flawed system that violates the constitutional rights of the accused.

And despite recent attempts by the SEC to address some of the concerns that have been raised, its in-house courts still lack many of the protections provided under the Federal Rules of Civil Procedure and the Federal Rules of Evidence, such as full discovery rights and the right to jury trial.

So the solution envisioned under the Due Process Restoration Act, my bill, is a simple one: Simply allow defendants the option to have their cases moved to a district court where robust due process protection exists.

The legislation maintains the ability of the SEC to commence an administrative proceeding in cases where the SEC, for example, may be seeking to bar someone from practicing from their Commission. And importantly, the bill does not mandate that certain cases automatically move to a district court. Instead, it leaves the decisions up to the defendant.

So if the administrative proceedings are as fair and impartial as the SEC says they are, under the bill those defendants would have the ability to remain within the SEC's in-house tribunal.

Hopefully, we can all agree that enforcement is an essential part of the SEC's mission, but we can also agree that the rights of the innocent must also be protected when the SEC takes actions that can destroy the career and reputation of an individual.

So the Due Process Restoration Act would help protect the innocent against government overreach. And I look forward to hearing from our witnesses today on this important matter.

With that, I yield to the gentlelady from New York for 3 minutes.

Mrs. MALONEY. I thank the gentleman for calling this hearing and for yielding to me.

And this hearing will address a series of legislative proposals, most of which address capital formation issues. They are intended to make it easier for companies to raise capital.

I am proud to be a cosponsor of one of the bills, the SEC Small Business Advocate Act, which my colleague Mr. Carney has worked so hard on. This bill would create an Office of the Advocate for Small Business Capital Formation within the SEC and would also create a permanent Small Business Advisory Committee at the SEC.

This is a common-sense proposal. It is actually modeled off of the provision in the Dodd-Frank Act which established the SEC's Investor Advisory Committee.

Ms. Sinema and Mr. Fitzpatrick also have a bill that would provide very targeted relief on the auditor attestation requirement in the Sarbanes-Oxley Act. All of the Democrats on this committee, myself included, voted against a bill last Congress that would have provided a blanket exemption from this requirement for roughly 75 percent of all public companies.

But I am intrigued by this compromise bill from Ms. Sinema, which is substantially more narrowly targeted. In effect, the bill would only provide limited relief and only to companies that can prove that they don't have enough revenue to pay for the auditor attestation requirement.

So I will be very interested in hearing more from our witnesses about this proposed compromise.

Finally, the Due Process Restoration Act would overhaul the SEC's administrative courts. I am very concerned about making changes that could weaken the SEC's enforcement authorities as well as their ability to quickly and fairly prosecute wrongdoers.

It is also important to remember that the SEC has long had the authority to try certain cases in an administrative forum rather than in Federal court. And we simply expanded this authority in Dodd-Frank because it has been such a useful tool.

In fact, people forget that much of our insider trading law was developed in an administrative case, the insider trading case of *Katie Roberts* in 1961 was an administrative opinion and the Supreme Court later adopted much of the *Katie Roberts* analysis as the basis for insider trading law.

So I think the SEC's administrative forum has been a useful tool. And I will be interested to hear from our witnesses about this proposal.

I look forward to all of your testimony and the exchange we will have. Thank you for being here, and I yield back.

Thank you.

Chairman GARRETT. Thank you. The gentlelady yields back.

I now yield to the vice chairman of the subcommittee for 2½ minutes.

Mr. HURT. Thank you, Mr. Chairman—

Chairman GARRETT. For 1½ minutes.

Mr. HURT. Thank you, Mr. Chairman.

And I thank the witnesses for appearing today in this important hearing.

I represent a rural district in Virginia, Virginia's 5th District. It stretches from the northern part of Virginia in Fauquier County to

the North Carolina border. As I travel across my district, I am reminded by my constituents again and again that the number one concern that they face is jobs and the economy. At a time when our economy is still struggling, Congress must do everything possible to help our small businesses achieve success.

These entities are our Nation's most dynamic job creators and their success is essential to our economy and American working families depend upon their success.

Every one of the measures we are considering today is designed to achieve that goal, whether that means establishing an office for small business capital formation, reducing the size of the administrative state or helping startups market their securities to a larger poll of investors, the goal is to help our Nation's small businesses achieve that success.

One such measure we are considering today is the Helping Angels Lead Our Startups Act, or HALOS Act. If enacted, this legislation would help startups by allowing them to better market their securities and to take part in economic development events like demo days where these startups can interface with potential investors without the risk of violating Federal securities law.

If adopted, the HALOS Act would alleviate the burden placed on startups with regard to privacy and compliance concerns which often require entrepreneurs and startups to take on burdens that are unnecessary and disproportionately expensive for small firms. These burdens have a significant impact on an entrepreneur's ability to deal with investors because of the risk of having their interactions with investors viewed as general solicitations or advertisements in violation of the Federal securities laws.

The adoption of the HALOS Act would be an important step in continuing the success that this committee has achieved in the bipartisan JOBS Act.

I look forward to the testimony of each of our distinguished witnesses.

I thank the chairman and yield back the balance of my time.

Chairman GARRETT. Thank you, and the gentleman yields back.

And now for 2 minutes, Ms. Sinema.

Ms. SINEMA. Thank you, Chairman Garrett and Ranking Member Maloney, for holding this legislative hearing.

I have heard from companies throughout my district that burdensome and unnecessary regulations continue to stifle their ability to grow and succeed. My bipartisan bill, the Fostering Innovation Act, provides targeted regulatory relief for companies on the cutting edge of scientific and medical research.

The bill adds an additional 5 years to the current JOBS Act exemption from auditing requirements under Sarbanes-Oxley for emerging growth companies that have an annual average revenue of less than $50 million and less than $700 million in public float.

This common-sense exemption will help ensure that costly regulations don't stand in the way of success for companies with a research-driven business model.

I am also a sponsor of the Helping Angels Lead Our Startups Act, or the HALOS Act. This bipartisan bill provides a clear path for startup businesses to connect with angel investors and venture

capitalists through demo days without being subject to onerous verification requirements.

Demo days are business-planned competitions, startup days, innovation summits, and other public forums that introduce entrepreneurs to potential investors. But because of confusion under current law, small businesses that need equity capital may forgo these events, losing opportunities to meet not only accredited investors, but also students, professors, and business professionals whose input and eventual investment could be invaluable.

I am committed to working with my colleagues on both sides of the aisle to ensure that Arizona's innovative small businesses have every opportunity to thrive.

So thank you to Mr. Chabot, Mr. Hurt, and Mr. Fitzpatrick for working with me on these common-sense, bipartisan bills.

And thank you again to Chairman Garrett and Ranking Member Maloney for holding today's hearing.

I yield back my time.

Chairman GARRETT. The gentlelady yields back.

The gentleman from Maine is recognized for 1 minute.

Mr. POLIQUIN. Thank you, Mr. Chairman.

I want to thank Chairman Garrett and Chairman Hensarling for bringing forward the Small Business Capital Formation Enhancement Act in a draft format today that I am sponsoring.

I also want to thank Congressman Juan Vargas from California who will be the lead cosponsor on this bill.

We all know that 80 percent of the new jobs in America are created by small businesses. But often, small businesses can't get the traditional loans from banks that they need to grow and expand and to hire more workers, so it is so important for our small businesses to be able to access our capital markets, the most liquid in the world, to make sure they have that lifeline.

Now, it doesn't matter if you are a boat builder in Ellsworth, Maine, or you are a call center in Lewiston, Maine, those jobs are critically important to our district and other employers throughout the country.

Now, during the past 35 years, as required by law, the SEC holds a forum that combines government officials and the private sector to make sure we come up with the best ideas possible on how our small businesses can access capital so they can grow and hire more workers. And we get the best academics and businesspeople, industry people and attorneys and government folks in the same room so we can come up with the recommendations.

Now, one of the problems we have, Mr. Chairman, is that this group every year comes up with some terrific recommendations that should become part of the rulemaking here in Congress or part of legislation that we sometimes advance here in this committee. But the SEC is not required to do anything with these recommendations.

So all this Act does is require that the SEC access this information, take it very seriously, and issue a public statement on whether or not they are going to use these recommendations to further capital access in America.

So with that, Mr. Chairman, again I want to thank you very much for letting me introduce this legislation in draft form.

And I thank Congressman Juan Vargas for being a lead cosponsor on this bill.

Chairman GARRETT. The gentleman's time has expired. And I thank the gentleman for his work on the legislation and for him introducing the bill.

We will now turn to our panel. And again, I welcome everyone here on the panel and I thank you very much for being with us. You have all submitted written testimony. I have reviewed it, and I suggest the subcommittee has reviewed it as well.

You will be given at this point 5 minutes to address the subcommittee. For those of you who have not been here before, there should be in front of you indicator lights: green menas you have 5 minutes; yellow means you have 1 minute left; and red means you are out of time. And without objection, each of your written statements will be made a part of the record.

So with that, we will turn to the professor, Mr. Grundfest. Welcome to the panel, and you are recognized for 5 minutes.

STATEMENT OF THE HONORABLE JOSEPH A. GRUNDFEST, WILLIAM A. FRANKE PROFESSOR OF LAW AND BUSINESS, STANFORD LAW SCHOOL; AND FORMER COMMISSIONER, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. GRUNDFEST. Great. Thank you, Chairman Garrett, Ranking Member Maloney, and distinguished members of the subcommittee. I would like to thank you for the opportunity to address matters that are important to the enforcement of our Nation's securities laws in general and to the issues that are raised by H.R. 3798, the Due Process Restoration Act of 2015 in particular.

A few brief words of introduction. I am the William A. Franke professor of law and business at Stanford Law School. I am senior faculty at the Rock Center on Corporate Governance at Stanford University. And I served as a Commissioner of the United States Securities and Exchange Commission from 1985 to 1990.

The substance of my testimony this morning can be summarized in a single word: balance. There should be a reasonable balance between the cases that the Commission decides to pursue through its internal administrative proceedings and those it decides to pursue in Federal court. And as for cases brought as administrative proceedings, there should be a reasonable balance between the respondent's rights to mount an effective defense and the Commission's reasonable interests in the prompt and effective enforcement of our Nation's securities laws.

There is, however, cause for concern that both processes are out of balance from many different perspectives. Legislative proposals of the sort that this committee is exploring this morning can, I believe, help restore a more effective equilibrium.

The SEC's administrative procedures have been criticized for decades. Critics have complained of a lack of depositions, the imposition of a rocket docket, the admission of hearsay evidence, the absence of a jury, bias by administrative law judges, long delays in appeals to the Commission itself, and the incongruity of an appeal to the same body that initially authorized the complaint.

These concerns have recently been compounded by SEC statements suggesting a plan to increase the number of enforcement actions filed as administrative proceedings and correspondingly to reduce the number of actions filed in Federal civil court.

The Commission has also clearly signaled its intent to insist on Chevron deference to its interpretation of the Federal securities laws, even when a significant number of Federal judges disagree with the Commission. Indeed, a sitting Federal judge has warned of serious adverse consequences for the evolution of the Federal securities laws if the Commission succeeds in this endeavor.

For all of these reasons, concern has mounted about the fairness of the SEC's internal administrative procedures and the frequency with which the agency resorts to administrative proceedings and not to Federal court.

To the Commission's credit, it has not been deaf to these concerns. It has recently proposed to amend its rules governing administrative proceedings so that instead of prohibiting all depositions, respondents will now be permitted to take up to five. But these are minor concessions given the litany of concerns that have been raised about the Commission's internal procedures.

Indeed, as a leading commentator in The New York Times recently observed, these are, "at best, small steps in responding to criticisms over truncated rights."

The challenge for Congress is to consider a legislative strategy that might help restore a more effective balance in the Commission's internal procedural rules and in the process by which the Commission decides which cases to file in Federal court and which to bring as administrative proceedings.

One possible approach to this challenge would be to consider legislation that would help assure that appropriate cases are heard in Federal courts and by administrative law judges, and the same legislation could provide incentives for the Commission to reform its internal procedures so that they are viewed as reasonable by the Federal judiciary.

This proposal would categorize SEC enforcement proceedings as falling into one of three groups. The first group of cases would involve proceedings that Congress determines can remain in the administrative process and that don't, as a rule, require the greater safeguards available under the Federal Rules of Civil Procedure or the Federal Rules of Evidence. Examples of these cases might include late filing cases, net capital violations, and a host of other matters that should not clutter the dockets of the already overburdened Federal courts.

The second group of cases would be composed of cases that raise questions that Congress considers particularly well-suited for resolution in Federal court. Examples of these cases might include insider trading prosecutions, or fraud in the sale of securities. As to these cases, respondents would have an unconditional right of removal, much as they would under the legislation being considered today, H.R. 3798.

The third group would be composed of cases that fall in neither the first nor second categories. Respondents in these cases could have a right to petition the Federal courts for an order of removal that would be granted at the discretion of the judge. The entire

process could be modeled on Federal Rule of Civil Procedure 23(f) which creates a right to petition for interlocutory review of decisions on motions for class certification.

This tripartite approach can, I believe, lead to an appropriate balance that does not interfere with the SEC's legitimate interest in the fair and efficient enforcement of the Nation's securities laws and protects the legitimate interests of respondents in these proceedings.

Thank you very much.

[The prepared statement of Mr. Grundfest can be found on page 49 of the appendix.]

Chairman GARRETT. I thank the gentleman.

Now turning next to the representative from the biotech industry. Mr. Hahn, you are recognized for 5 minutes.

STATEMENT OF BRIAN HAHN, CHIEF FINANCIAL OFFICER, GLYCOMIMETICS, INC., ON BEHALF OF THE BIOTECHNOLOGY INDUSTRY ORGANIZATION

Mr. HAHN. Good morning, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. My name is Brian Hahn and I am the CFO of GlycoMimetics, a clinical stage biotech company with 40 employees. We are conducting clinical trials to treat patients suffering from sickle cell disease and acute myeloid leukemia.

GlycoMimetics' story is mirrored by our colleagues cross bio's membership. Our product candidates were developed by brilliant scientists and our early research was funded by venture capital. When it came time to conduct expensive clinical trials, we turned to the public market for financing.

Growing biotechs do not generate product revenue. We are 12 years into our research and we are still years away from our first dollar in product revenue. Because of this unique development pathway, investment capital is vitally necessary to support the $2 billion search for new medicines.

GlycoMimetics went public in January of 2014, raising $64 million that has funded our research for the last 2 years. Our IPO was supported by the JOBS Act, which has stimulated more than 180 biotech IPOs by granting company-enhanced access to investors and reducing their regulatory burdens.

Spending capital on one-size-fits-all compliance requirements is uniquely damaging to emerging biotechs. Every dollar spent on a reporting burden is a dollar diverted from the lab.

The JOBS Act has been so successful because it has allowed emerging growth companies to focus capital on science rather than compliance. In particular, I am thankful that the emerging growth companies are given a 5-year exemption from compliance with Section 404(b) of the Sarbanes-Oxley (SOX) Act.

The external attestation required by SOX does not provide meaningful information to biotech investors, yet is extremely costly for a pre-revenue company. Our investors demand information about our science, our patients, and our regulatory pathway, but they do not want us to spend up a million dollars on compliance requirements that don't give any insight into our business.

The JOBS Act's 5-year SOX exemption has saved millions of dollars for growing biotechs, but most will still be pre-revenue when the IPO on-ramp expires.

GlycoMimetics expects our annual expenses to increase by upwards of $350,000 starting in year 6 on the market, capital that could be used to treat over a dozen patients in the clinic each year.

I strongly support the Sinema-Fitzpatrick Fostering Innovation Act which would extend the JOBS Act 404(b) exemption for an additional 5 years for certain small companies.

This bill would allow growing businesses to remain exempt from Section 404(b) through year 10 on the market if they maintain average annual revenues below $50 million and a public float below $700 million.

If focusing on revenues is the key metric of a company, size is vital to the reform. Public float is a measure of investors' predictions about our future potential, but revenue is a true window into a company's size today and our ability to pay for expensive compliance requirements that are not meaningful.

We are all working toward the first dollar of revenue. Until that point, we need to focus all of our investment capital on our research rather than on our compliance obligations. This important bill recognizes that a low-revenue company that has been on the market beyond the 5-year EGC window is still very much an emerging, growing company.

The Fostering Innovation Act will build on the success of the JOBS Act by reducing compliance costs for small businesses. These cost savings will allow companies like mine to focus solely on life-changing science, so I strongly support this bill.

I also support efforts to encourage the SEC to enact capital formation initiatives. The JOBS Act came out of industry proposals that the SEC could have instituted on its own, but Congress had to step in.

The SEC Small Business Advocate Act and the Small Business Capital Formation Act would improve the SEC's policymaking processes by bringing small businesses into the room, hopefully encouraging smart policymaking that will support capital formation and reduce regulatory burdens.

The JOBS Act has shown us the strong impact that a move away from one-size-fits-all regulatory burdens can have on capital formation.

I applaud the subcommittee for considering further cost-saving initiatives and look forward to answering any questions you may have.

[The prepared statement of Mr. Hahn can be found on page 58 of the appendix.]

Chairman GARRETT. I thank the gentleman for your testimony.

Dr. Carcello, welcome to the panel, and you are recognized for 5 minutes.

STATEMENT OF JOSEPH V. CARCELLO, EY AND BUSINESS ALUMNI PROFESSOR, AND DEPARTMENT CHAIR, DEPARTMENT OF ACCOUNTING AND INFORMATION MANAGEMENT, HASLAM COLLEGE OF BUSINESS, UNIVERSITY OF TENNESSEE, KNOXVILLE

Mr. CARCELLO. Thank you. Good morning, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. Thank you for giving me the opportunity to speak with you today about legislative proposals that would affect the U.S. capital markets.

I can't reduce my testimony to one word, but I can reduce it to one sentence: Capital markets do not exist without investors.

I have served as a professor at the University of Tennessee for over 20 years where I teach accounting, auditing, and corporate governance. My remarks are also informed by my service on the SEC's Investor Advisory Committee and the PCAOB's Investor Advisory Group.

Turning first to H.R. 3784, it would establish an Advocate for Small Business Capital Formation and a Small Business Capital Formation Advisory Committee within the SEC. This bill appears premised on a lack of access that small business has to Congress and/or to the SEC.

The facts belie the existence of a problem, given recent changes to small-business regulation contained in the Dodd-Frank Act and in the JOBS Act. Even if Congress concludes that the interests of small businesses need better representation, the bill as drafted is flawed.

The advisory committee is essentially a lobbying group for small businesses, a lobbying group that Congress would have granted a government imprimatur to.

Finally, H.R. 3784, as well as a number of the other bills being discussed this morning, seem to view any shortfall of capital experienced by small businesses as a problem of demand. That is, small businesses lack capital due to onerous and high-cost regulation.

Leaving aside the veracity of this viewpoint, this argument ignores the suppliers of capital: investors. Creating a quasi-lobbying group to seek a more favorable regulatory climate for small businesses may succeed in reducing the cost of regulation, but at the potential cost of greater information risk to investors. Such an outcome would actually be counterproductive for small businesses as capital would either exit the market or would only be available at a much higher cost.

Turning to H.R. 3798, this bill would give defendants subject to SEC proceedings before an ALJ the option to have those proceedings terminated. If the SEC wanted to proceed, the Commission would have to bring the charges in U.S. district court.

Before changing the SEC's enforcement process, it is important to remember that Congress, first in the Sabanes-Oxley Act and then in the Dodd-Frank Act, made it easier for the Commission to bring certain enforcement actions before an ALJ. Congress should not underestimate the collateral damage that may be done by changing the SEC's enforcement powers.

Giving defendants the right to effectively choose the venue in which they will be tried is unlikely to be in the best interests of

society and will almost certainly make it more difficult for the SEC to deter and punish securities law violations, including fraud.

Finally, the Fostering Innovation Act would extend the waiver of auditor reporting on the effectiveness of an issuer's controls over financial reporting for certain emerging growth companies from 5 years to as long as 10 years. Further expanding the number of companies exempt from 404(b) is ill-advised because auditor reporting on ICFR is valued by investors.

In a recent survey by the PCAOB's Investor Advisory Group—by the way, $13.4 trillion of capital was represented by those respondents, 72 percent of surveyed institutional investors indicated that they relied on the ICFR opinion either extensively or a good bit.

Any decision to exempt smaller public companies from auditor internal control testing ignores the ample evidence that internal control problems are often most serious in smaller public companies. In addition, those companies charged with financial statement fraud by the SEC tend to be relatively small.

If Congress decides to move forward with this proposal, I have an alternative for Congress to consider. Rather than just giving a blanket exemption after 5 years, assuming the $700 million threshold is not hit and the $50 million revenue is in place, put it to a vote of the people who actually own the company: the investors.

If my colleagues on this panel are right, they will overwhelmingly vote for a further delay in that requirement. And if they value 404(b), they won't. So let the market decide, let investors who own the company make the decision.

I look forward to the committee's questions.

[The prepared statement of Dr. Carcello can be found on page 40 of the appendix.]

Chairman GARRETT. Thank you.

From Horizon Technology Finance, Mr. Mathieu, welcome to the panel, and you are recognized for 5 minutes.

STATEMENT OF CHRIS MATHIEU, CHIEF FINANCIAL OFFICER, HORIZON TECHNOLOGY FINANCE, ON BEHALF OF THE SMALL BUSINESS INVESTOR ALLIANCE (SBIA)

Mr. MATHIEU. Thank you. Good morning, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee.

I am here today representing the Small Business Investor Alliance, or the SBIA, which is the trade association for lower-middle-market private equity funds, SBICs, and business development companies, or BDCs, and their institutional investors. SBIA members provide vital capital to small and medium-sized businesses across the country.

My name is Chris Mathieu, and I am the CFO and co-founder of Horizon Technology Finance Corporation, an externally managed, publicly traded BDC. I have been involved in the accounting, finance, and venture debt industry for more than 25 years.

Horizon is a specialty finance company that lends to and invests in development and growth stage companies in the technology and life science industries. Our investments take the form of secured loans or venture loans to companies backed by established venture capital and private equity firms.

Having served as a steward of investor capital for the last 25 years in both public and private markets and for both institutional and individual investors, I believe I have a wide and deep perspective on the importance of having an advocate among the decision-makers within an organization and industry and its underlying sectors.

I am here to express our support for a bipartisan bill called the SEC Small Business Advocate Act, or H.R. 3784, introduced by Representatives Carney and Duffy.

In a speech given by former SEC Commissioner Daniel Gallagher on September 17, 2014, the genesis of this Act was born. In his opinion, Mr. Gallagher argued that the SEC does not have adequate structure in place to consider the views of small businesses. He argued that the SEC consistently overlooks the impact of their decisions on small businesses and this could be a detriment to capital formation.

We agree with Mr. Gallagher's assessment and believe Congress needs to put a permanent structure in place at the SEC to give a stronger voice to small business and capital formation issues. The Act is the favored approach by the industry to create this new structure.

The Act strengthens the voice of small business at the SEC by making significant changes to the way the SEC hears from small-business stakeholders, and responds to stakeholder requests and makes recommendations to Congress and the SEC to improve the ability of small business to access capital.

The advocate will have similar powers to the Dodd-Frank-created Office of the Investor Advocate, giving small businesses an equal footing with investors in influence over the SEC actions.

For example, the legislation charges the advocate to produce an independent annual report to Congress on its recommendations. This report will provide a summary of the most serious issues encountered by small business and small-business investors, and recommendations for change to regulations and other guidance that may be appropriate to resolve these problems.

Congress would also benefit greatly from this office. Legislating good policy generally includes technical assistance and input from regulators. The technical assistance given to Congress suffers from the same bias and focus on large corporations. Congress would benefit from having small-busineses' issues included in both the technical assistance it receives and in the way regulations are crafted when implementing legislation. Better information means better legislation.

SBIA also supports the HALOS Act. This legislation helps address a problematic issue in the raising of private capital surrounding the definition of general solicitation in the matching of investors with startup investment opportunities.

SBIA encourages the committee to pass this legislation to provide associations like the SBIA and other fund managers that are members of the association the protection they need to facilitate the meeting of potential limited partner investors and general partner investment managers.

We also support the Small Business Capital Formation Act. This legislation would require the SEC to respond in a public statement

to each of the suggestions by the Government-Business Forum on Small Business Capital Formation.

The bill requires that the SEC acknowledge the receipt of the forum's suggestions and explains why they will or will not adopt the suggestions.

I want to thank the committee again for holding this hearing today on these important pieces of legislation. And I look forward to answering any questions.

And I also ask for your support and cosponsor of this legislation. Thank you.

[The prepared statement of Mr. Mathieu can be found on page 66 of the appendix.]

Chairman GARRETT. I thank the gentleman.

Last, but not least, Mr. Quaadman from the U.S. Chamber of Commerce, you have 5 minutes.

STATEMENT OF TOM QUAADMAN, SENIOR VICE PRESIDENT, CENTER FOR CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF COMMERCE

Mr. QUAADMAN. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee.

A prosperous, growing economy needs to have a strong and fair securities regulator to facilitate efficient capital markets. I know that is a priority of Chair White as well as Director Ceresney, but we were looking at SEC enforcement long before their tenure.

This past July, the Chamber released a report on SEC enforcement that included 28 recommendations for how the SEC can improve enforcement oversight and investigations and, what I would like to talk about today, due process.

The use of administrative proceedings has changed radically over the last 25 years that now today administrative proceedings are the primary means of adjudicating violations. Administrative proceedings are also not an even playing field. The SEC has unfettered right to discovery, and can take years to bring a case, whereas defendants have 90 days to prepare their defense, lack adequate discovery, and no right to deposition and have no protection of evidentiary rules.

The due process recommendations that we made this past July included: alternative dispute resolution, so that the SEC can quickly resolve very minor violations; clarifying the use of administrative proceedings, so that those ministerial matters can solely be handled through administrative proceedings; that those serious offenses where there is well-settled law in Article III courts could have a pathway to district courts; that the 1993 rules of practice be replaced with new rules of practice that include rights of discovery, ability to have depositions, as well as the reliability of evidence including hearsay evidence, as well as the right of removal to district court and for the defendant, not the government, to decide the right to a trial by jury.

The SEC, as has been mentioned, has proposed limited amended rules of practice; I will call it a crawl in the right direction. We are going to file a comment letter at the end of this week, which we will be happy to provide to the committee.

We support the Due Process Restoration Act, but would make a couple of recommendations for amendments. First, we believe that it should include the 1933 Securities Act, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. This will allow for the major enforcement matters that have well-settled law in Article III courts to have a pathway to district courts.

We also believe that there should be one burden of proof. We understand what the reasoning is behind the clear and convincing standard, but we believe that there should be one standard of proof so that there is balance.

I believe that the passage of an amended version of the Due Process Restoration Act, as well as the other due process enhancements that we had recommended, would allow the SEC to be a strong enforcer of the law and give defendants the ability to defend themselves.

We also support the SEC's Small Business Advocate Act of 2015. However, we believe there should be a couple of amendments as well. First, the powers of the investor advocate and small-business advocate should be similar and mirror each other. So, for instance, the small-business advocate should have the right to appoint a non-voting member to the Investor Advisory Committee.

Similarly, it is a very longstanding position of the Chamber that advisory committees of the SEC and its subordinate organizations also be transparent in their processes. Therefore, we would recommend that the bill be amended so that the Small Business Capital Formation Advisory Committee as well as the Investor Advisory Committee be subject to the Federal Advisory Committee Act and the Sunshine Act.

We also agree that the SEC has had a difficult time in keeping up with evolving markets. We believe that the Small Business Capital Formation Enhancement Act will allow the SEC to modernize its regulations and overcome inertia.

We also support the HALOS Act. We believe that this will help unlock capital. However, we also believe there need to be strong investor protections in place and that information is going to credited investors. We believe that there should be a date-certain retrospective review after implementation for the SEC to review if the HALOS Act is both facilitating investor protection, promoting investor protection and facilitating capital formation.

Finally, I would just like to thank Chairman Hensarling, this subcommittee, and the Financial Services Committee for including key capital formation improvements in the DRIVE Act. We believe that those are very important and are an important build upon the JOBS Act.

I look forward to working with the committee on these bills and look forward to any questions you may have.

[The prepared statement of Mr. Quaadman can be found on page 73 of the appendix.]

Chairman GARRETT. Thank you. The gentleman yields back, and I thank you for the testimony, and also amendment ideas.

But that is what these hearings are for, to see how we can improve things.

So at this point, I recognize myself for 5 minutes for questions.

I guess I will go to Mr. Quaadman first. You heard Dr. Carcello's comments, and his last comment was on the Fostering Innovation Act bill. One of his comments was, well, if you did it, maybe what you should do is allow the markets to decide and allow the investors in that field to be able to opt in or opt out.

You heard that comment?

Mr. QUAADMAN. Yes, I did, sir.

Chairman GARRETT. That was intriguing to me. So if we were to go that way, maybe we shouldn't just apply that to that sphere, maybe we should apply that to a whole myriad of Dodd-Frank pieces of legislation and allow investors to be able to opt out all of that.

I see Dr. Carcello agreeing.

Mr. CARCELLO. Yes.

Chairman GARRETT. I will give Mr. Quaadman and Dr. Carcello 10 seconds on each one.

Mr. QUAADMAN. Sure. I think that is a very interesting suggestion. I agree with you that if you want to go down that logical road, then why not have that process for a whole myriad of rules and regulations.

One thing I just want to do, throw out one area of concern about, we do believe that internal controls are important for a company to grow from small to big. In fact, BIO and the Chamber have been working together to address some concerns with the SEC and the PCAOB where those costs have actually ratcheted up for many companies.

I think it is something worthy of discussion, but I think we also need to be very concerned as well of an uneven playing field.

Chairman GARRETT. Yes.

Dr. Carcello?

Mr. CARCELLO. Just very briefly, I would extend it broadly. I would even extend it to the external audit of the financial statements. I think if that had to be selected by investors, you would find greater competition and probably greater responsiveness to market needs.

Chairman GARRETT. I was initially troubled by your ideas because I was thinking you were looking at this as a zero-sum game as far as our U.S. markets. But I guess if you extended this as far as you would go, you would actually potentially open up our markets by making us on a more level playing field as far as investor concerns across the spectrum. So, thank you for that.

Let me go back to the other end of the dais here.

Mr. Grundfest, you laid out three pots if you will, three silos as far as what these could fall into, three buckets, pro forma matters that would remain here, the clear-cut ones that were over here, and then other ones that are in the middle. Maybe you could just spend 20 seconds on the ones in the middle. What would be the criteria? Because if this is basically left to a judge to decide, the judge is going to have to have some sort of criteria in order to make that determination, right?

Mr. GRUNDFEST. Absolutely, Mr. Chairman. And if you take a look at my written testimony, the very last footnote on the very last page lays out six considerations in particular that a court might view as what would be called core factors with an analogy

to rule 23(f). They would be first, the presence of complex regulatory matters that are better resolved by an administrative law judge than by a jury or an Article III.

Let's face it, there are certain levels of complexity that belong with the SEC. You don't want to clutter the Federal court docket if you have that kind—

Chairman GARRETT. That is in the first category. I got that.

Mr. GRUNDFEST. Yes. I'm sorry?

Chairman GARRETT. That is in the first category, clearly, the ones that are clearly—

Mr. GRUNDFEST. Actually, even in the toss-up cases.

Chairman GARRETT. Okay.

Mr. GRUNDFEST. Even in the toss-up cases, sometimes you have complex regulatory matters. A judge can look at it and say, we really need the expertise of the SEC and an ALJ to address these types of issues.

Then you could look at the value of fact-finding by a jury as opposed to an administrative law judge. Sometimes they say, we have questions of credibility and we would rather have a jury of 12 peers view these issues rather than have the decision being made by an administrative law judge.

Chairman GARRETT. Let me just stop you on that because I can go through the other six in a moment.

Mr. GRUNDFEST. Sure.

Chairman GARRETT. But Mr. Grundfest, on that point, if you ask the average person on the street, don't we have a right in the United States to have a decision made on guilt or innocence, if you will, by a jury of our peers? That doesn't occur here, correct? The fact finder is not a jury of our peers. And is that a violation of our Constitution? Is that a usurpation of the powers of Article III judges, of Article III of the Constitution?

Mr. GRUNDFEST. Yes. And there have been a number of cases that have been popping up where courts have been expressing a lot of concerns regarding this use of administrative proceedings.

We have now the system is set up that the government decides whether or not there is going to be a trial by jury, which puts defendants at a severe constitutional disadvantage.

Chairman GARRETT. Right. And at the end of the day, what are we talking about as far as the penalties that could be imposed? Are these not life-and-death decisions actually being made by these inside tribunals?

Mr. GRUNDFEST. Yes. In fact, Russell Ryan, who is a former Assistant Director of Enforcement at the SEC, wrote an op-ed in The Wall Street Journal last year where he was citing that these proceedings are being used as quasi-criminal proceedings.

So if you take someone like a Nelson Obus with Wynnefield Capital—

Chairman GARRETT. Okay.

Mr. GRUNDFEST. —he was able to get into district court under the old rules and was acquitted after 12 years and $13 million. He would not have the opportunity to do that today and would not have had the discovery tools that allowed him to unearth the evidence that acquitted him.

Chairman GARRETT. Thank you very much.

And with that, I turn to the gentlelady from New York, the rnaking member of the subcommittee, for 5 minutes.

Mrs. MALONEY. Thank you.

Professor Carcello, I would like to ask you about the Due Process Restoration Act. This bill would permit a defendant rather than the SEC to choose the venue of the enforcement action, essentially whether it is initially tried in an administrative forum or the Federal district court.

Now when the SEC is bringing enforcement action, it can choose the venue that best serves the interests of the investors and the public. A defendant in an enforcement action, on the other hand, would likely choose the venue that is in the best interest of the defendant.

So the bill, for example, could potentially allow a well-funded defendant to choose a district court knowing that the Federal district courts are overwhelmed and that may delay a trial, realistically, for many years.

In your opinion, do you think allowing a defendant to have this choice is in the public interest?

Mr. CARCELLO. No. And the reason why—the choices here are very clear. It is obvious to the defendant it is in his or her interest to have a choice of venue. It is, I think, clear that from a societal perspective the SEC is going to choose the venue that they think best serves investors and best serves society.

And I think it is important for Congress and this committee to think carefully about the fact that the greater use of ALJ, as I have talked about in my testimony, was facilitated by actions Congress took. Congress took action in 2002 in Section 305 of SOX to facilitate the ability of the SEC to move in this venue. They took action in Dodd-Frank in 929(p) to facilitate the ability of the SEC to move in this venue.

Both of those Acts followed severe market disruptions, massive financial fraud, to the point that our markets were essentially paralyzed in 2001 and 2002.

And I would point out to this committee that in the vote against SOX, there were fewer people who voted against SOX—look it up—than voted against declaring war on Japan after Pearl Harbor was bombed. Okay? And President Bush was the President then, hardly a known liberal. So the markets were paralyzed.

Dodd-Frank was not nearly as bipartisan, clearly, but followed essentially close to the complete implosion of the financial sector in this country. And so Congress viewed market failures there. They viewed it as a situation where the SEC, among many other things, needed greater enforcement tools.

So I think the question the committee needs to answer—and it is really a very simple question—is what has changed? What has changed? Why did the enforcement tools that you have created within the last 15 years, it is not 50 years ago, this is in the last 15 years, why are these enforcement tools no longer needed?

Mrs. MALONEY. To follow up, are you concerned that this would hinder the SEC's ability to crack down on bad actors in the securities market and especially with the funding constraints? We were just told from the screen that the SEC is funded 12 percent lower

than what their requests are, even though their responsibilities have grown.

So I would like to ask you to follow up on that, and then anyone else on the panel who would like to comment on whether you think this would hinder the SEC's ability to crack down on bad actors.

Dr. Carcello?

Mr. CARCELLO. Very briefly, to give others some time, yes, I think it clearly would. It would make it more difficult. I think even in Professor Grundfest's testimony, part of his testimony in his written remarks indicated that it would make it more difficult at the margin.

And the SEC, in many ways, is an underfunded agency. I think many people have viewed that for years. And so it is certainly going to make it more difficult for them to enforce the securities laws.

To the extent that there is, in the minds of some, a lack of fairness to the defendant, I think that is a legitimate concern. But I think there are other ways that can be dealt with.

Mrs. MALONEY. Would anyone else care to comment?

Mr. QUAADMAN. Yes, Ranking Member Maloney, if we repeal the Bill of Rights a lot more people would be in jail, but we wouldn't be a better country. The issue here is that if you had sufficient rules of practice and administrative proceedings and you had a right of removal, you would not have a stampede to district court, but at least you would give defendants the right to defend themselves.

The reason why we have a Bill of Rights is because prosecutorial powers are so great, the Founding Fathers wanted to put some safeguards there.

The issue here is we do not have constitutional safeguards, which also means there is a presumption that somebody is guilty until they are proven innocent.

Mrs. MALONEY. But they can appeal to Federal court, correct?

Mr. QUAADMAN. First, they have to—

Mrs. MALONEY. Wouldn't that be a safeguard?

Mr. QUAADMAN. But first, they have to appeal to the Commissioners themselves.

Chairman GARRETT. The gentlelady's time has expired.

The gentleman from Virginia, the vice chairman of the subcommittee, is recognized for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman.

Mr. Quaadman, I wanted to start with you. I was wondering if you could briefly talk about the importance of the angel capital markets and the importance of promoting policies here in Congress that encourage more investment by angel investors in startups.

Mr. QUAADMAN. Angel investors are an extremely important investment tool for startup businesses. They are actually the first line of accredited investors who are going into startups, so they are critical for business formation.

I think what we have clearly seen with the JOBS Act is the changes in general solicitation and the opening up of roadshows have been wildly accredited with the increase in IPOs and public company formation.

I think by helping to open up these venues for angel investors, if done in the right way, which they can be, I think that will certainly help business formation. And as I have testified before, we have seen over the last 7 years historic lows in business creation in the United States. So I think this is a critical reform we need.

Mr. HURT. And do you think that is particularly important in light of the pressures that have been on other participants in providing capital, namely banks and credit unions, the pressures that they have suffered from over the last 8 years?

Mr. QUAADMAN. Yes. Clearly we have seen with the implementation of the Basel III rules and other rules that are happening, there are disincentives now for banks to loan either through traditional business products or consumer financial products that are used for startups. So that market has receded, and we are now more dependent upon capital markets. So I think reforms like this, as with the BDC legislation and others, are very important in terms of moving forward.

Mr. HURT. Thank you.

I wanted to talk to Mr. Hahn and Mr. Mathieu for this next question. I was wondering if, beginning with you, Mr. Hahn, you could talk a little bit about the current general solicitation rules and how they unnecessarily impede the ability of startups to access capital under Reg D Rule 506(c), if you could talk a little bit about that, and then talk about our HALOS proposal and whether or not you believe that this proposal gets to the heart of solving that issue or improving that issue? And then maybe leave some time for Mr. Mathieu.

Mr. HAHN. Thank you. I can kind of start working backwards with the JOBS Act. We went public in January of 2014. And the test-the-waters provision of the JOBS Act was instrumental. That is why we had a successful IPO.

Working backwards toward that, though, most all of our funding was from venture capitalists. And over the years, when we were still private, we were always looking for different ways to raise money. So any expansion for private companies to get in front of more investors and to find more pockets of capital, would be a tremendous success to help more companies succeed.

Mr. HURT. Do you think that the HALOS proposal that we are considering today helps remove some of those barriers and enhances the ability of startups to access that capital?

Mr. HAHN. Yes, if it works, kind of similar to test the waters, it gives you more access with less barriers to get in front of more potential investors to tell the story of the company. In our case, our science is very complex, so it takes more meetings, more time to get people comfortable with our technology. I think that would definitely be helpful.

Mr. HURT. Mr. Mathieu?

Mr. MATHIEU. Yes, I would actually agree with Mr. Hahn. I think that solicitation is a broad subject and it really goes to common-sense of how you tell your story.

At Horizon, we often look at companies like Mr. Hahn's in their earlier stages as well as being public, so we actually like the stories, we like the time spent in developing the relationship. So I think the solicitation, broadening that flexibility is really impor-

tant, not just to raise equity capital in the private market, but also the public sector as well.

Mr. HURT. And I appreciate the testimony of both you and Mr. Hahn, in support of the HALOS Act. Do you think that the HALOS Act, if enacted, would help remove some of those impediments and encourage more angel investing in startup companies?

Mr. MATHIEU. I do, yes. And I think it is really a path to just improving a process that works, but can be improved.

Mr. HURT. Excellent, thank you.

I yield back the balance of my time.

Chairman GARRETT. The gentleman yields back.

Mr. Hinojosa is recognized for 5 minutes.

Mr. HINOJOSA. Thank you, Mr. Chairman.

I ask unanimous consent to enter two statements into the record regarding the legislative proposals we are considering today. The first one is a statement from Jennifer Taub, professor of law, Vermont School of Law, and the second is a statement by Public Citizen, a public advocacy organization here in Washington, D.C.

Chairman GARRETT. Without objection, it is so ordered.

Mr. HINOJOSA. Thank you.

I would like to thank the panelists for their appearance and testimony here today.

Our capital markets are the envy of the world because they are safe, transparent, and liquid. Emerging companies are the lifeblood of our economy. So ensuring that emerging companies have access to capital is an imperative if we are to maintain our global and financial leadership.

As we consider the proposals that aim to improve our capital markets, we must be careful not to undermine the safety and the confidence in our markets.

My first question is to John Grundfest. Professor, in your testimony you voiced some concerns that the SEC faces a crisis of confidence over the fairness of its internal administrative procedures. H.R. 3798, the Due Process Restoration Act, aims to address some of the issues raised by the critics by providing defendants to remove their case to a Federal district course, a venue of their choosing, and by increasing the SEC's standards from a preponderance of the evidence to a clear and convincing standard.

My question to you is, do you think these measures will address the concerns raised regarding the SEC's administrative proceedings?

Mr. GRUNDFEST. I think the bill is one approach that can be taken to these issues. And I think the existence of the challenge is actually effectively conceded by the Securities and Exchange Commission itself.

I think it is valuable for this committee to recognize that the Commission itself has decided that its historic approach of saying no depositions in any of its proceedings may actually not be fair, and for that reason the Commission itself has proposed increasing the number of depositions to up to five.

Now, in some of the more complex matters, the number of five could be viewed as being extraordinarily low, arbitrary, and capricious, given a case that might involve hundreds of thousands of documents, where the Commission itself may have taken testimony

from hundreds of witnesses. And in order to have a modicum of fairness, you need not go to one extreme and say we are going to depose absolutely everyone, but limiting the number of depositions to five might be viewed as arbitrary and also as unfair.

Mr. HINOJOSA. That is your opinion. Do you believe this bill will have the result of moving most, if not all, SEC proceedings to an already overly burdened Federal court docket?

Mr. GRUNDFEST. It could move a large number of important cases to Federal court docket. And out of concern for the loads that the Federal judges do face, an alternative approach might be to look at the three categories that I have suggested where you could carve out a set of cases where you don't have to have any right to bring it to a Federal—

Mr. HINOJOSA. The Federal courts in Brownsville all the way to El Paso on the Texas/Mexico border are just overloaded with different immigration cases and lots of other cases. And we just don't have enough Federal judges to take on more like you are suggesting.

My next question is to Joseph Carcello. The Small Business Capital Formation Enhancement Act would require the SEC to publicly assess the findings or the recommendations of the annual Government-Business Forum on Small Business Capital Formation. My question is, do you find it necessary to require that the SEC to also formally respond to each recommendation?

Mr. CARCELLO. Yes, that is a concern. My understanding is, last year the number of recommendations that came out of that forum was 20. My understanding also is that any participant in the forum can make a recommendation.

To the extent that these bills are patterned after Sections 911 and 915 of Dodd-Frank, and speaking as someone who, along with Professor Grundfest, is on the Investor Advisory Committee, I can tell you it is quite difficult for us to come to a consensus. There are 20 members in that group. Each of the five SEC Commissioners essentially have four picks. As you well know, the SEC is pretty ideologically divided, so the IAC is pretty ideologically divided.

Mr. HINOJOSA. They seem to resemble Congress.

Mr. CARCELLO. Yes, they seem to resemble Congress.

Mr. HINOJOSA. Do you think the bill will help the SEC—

Chairman GARRETT. The gentleman's time—I will permit the last question. Go ahead.

Mr. HINOJOSA. I yield back.

Chairman GARRETT. Okay.

Mr. Duffy is now recognized.

Mr. DUFFY. Thank you, Mr. Chairman.

I am concerned about the arguments that are being made that we can't allow due process because our Federal courts are overburdened. If that were the case, maybe what we would do in regard to criminal cases, we want to have the attorney general's office set up some form of administrative law judge so we can have the FBI investigate, the attorney general prosecute, to administrative law judges who are hired by the U.S. attorneys office. And then that therefore would be justice in the American criminal system.

But I think most Americans would scream wildly that that is not fair. And to think that we are going to now make the argument

that we can't go to Federal courts because they are overburdened, the better outcome then would be stay at the SEC and be guaranteed an adjudication of guilt is a better outcome for defendants, is absolutely insane.

I agree with Mr. Garrett's bill. We should give defendants an outlet to go to Federal courts and have their cases heard by an impartial group of judges and potentially juries.

Mr. Quaadman, do you agree with that analysis? Am I wrong on that? I am supposed to be spending my time on my own bill with Mr. Carney, but this is, anyway—

Mr. QUAADMAN. No, Mr. Duffy, I think you have hit the nail on the head. And the reason why I also mention about creating new rules of practice was, if you have fair due process in administrative proceedings, you are not going to have a stampede to district courts either. You might have large cases move over, but it is not going to be a stampede.

The other thing I just want to mention too, because this also shows how Kafkaesque this is, what got us involved in this to begin with was that a general counsel came in and talked about a situation where they had an issue that both the IRS and the SEC were investigating. And the IRS gave this company a document giving all their rights and responsibilities during the investigation and the SEC had nothing. So they are in complete no-man's land from the start of the investigation through. And then, when you go into the AP process, you have no right to discovery or anything. So it is a completely tilted playing field.

Mr. DUFFY. I did well as a former State prosecutor, won a lot of cases, but I have to tell you I would have had a much-improved record if I was able to try my cases in front of my own DA staff, no doubt. And I think that is why we see the rates of success so high at the SEC.

I do want to transition to the bill that I worked on with Mr. Carney in regard to our small-business advocate advocating for better capital formation with regard to our small businesses.

I think if you look at economic growth, we look at job creation, it is coming from our small, emerging growth companies and making sure that they have access to capital it is incredibly important that we get that right.

And I appreciate Mr. Carney's hard work and the bipartisan effort and the support that we have had on both sides of the aisle for this proposal.

We all agree that we want to protect investors. That is a really good thing. But we also want to make sure we have the right balance, I would argue.

And maybe to Mr. Mathieu, do you think we have struck the right balance between investor protection and capital formation specifically in regard to small businesses?

Mr. MATHIEU. I think currently, we are not fairly balanced. I think that is what this legislation is actually trying to do.

Mr. DUFFY. I would agree.

Mr. MATHIEU. And so I think we are trying to say that the SBIA supports this very strongly, because right now the small-business investor and the small-business operators don't have a fair say, a fair spot to express their position.

Mr. DUFFY. I would agree. And I think to have an advocate there who can talk about the good, the bad, and the ugly specifically to the Commission would benefit our small businesses and emerging growth companies.

I just want to make one comment. I know that some on the right have made some complaints, people are concerned about the growth of government. We have a really big debt. None of us ran, at least on this side of the aisle, to grow government and make it bigger. And some have said, well, this bill is a growth of government.

But I think that making sure that you have an advocate inside the SEC promoting policies that will support our small businesses so they can access capital, they can grow, they can create jobs, they are the next innovators, Mr. Hahn, of the next lifesaving products or the next iPad or Apple or whatever that technology may be.

To think that we are going to use the growth of government argument against good policies that help American businesses, I think is shortsighted.

Mr. Mathieu, would you agree with that?

Or Mr. Hahn, would you agree with that?

Does the growth of government for the small agency that is funded by fees, not by appropriation, is that small in comparison to what this does for the American small-business community?

Mr. MATHIEU. Yes, I think this is common-sense. It is a no-brainer. The incremental cost, if any, far supports the benefits that will come. The lack of support of small business from day to day has to change.

Mr. DUFFY. Mr. Hahn, quickly?

Mr. HAHN. The SEC doesn't often act on the recommendations of the advisory committee or the Government-Business Forum. The small-business advocate would bring those industry stakeholders further into the SEC's decision-making process.

Mr. DUFFY. Thank you, I yield back.

Chairman GARRETT. Thank you.

There are some people on the right who are making that argument. I appreciate that.

Mr. Green is now recognized for—oh, Mr. Carney is recognized for 5 minutes.

Mr. CARNEY. Thank you very much, Mr. Chairman, and Ranking Member Maloney for having this panel today and for all of you who have come to testify.

A few years ago, I worked with my friend on the other side of the aisle, Mr. Fincher, on the JOBS Act, and in particular the IPO on-ramp. I come from the State of Delaware; my district includes the whole State of Delaware. We pay very close attention to corporate formation and business development issues. Most of the 500 companies are incorporated in our State.

And folks whom I know well, who do that business in the Division of Corporations have been reporting to us that companies were no longer going to IPO. And we had had a real problem with that, a cutback, and there are lots of different reasons.

And Treasury convened a group of business leaders. And out of that confab came a number of ideas to try to promote businesses, emerging growth companies to go to an IPO, because the facts were

that companies that sought public financing through an IPO were in a growth stage creating more jobs. And what had happened was for some of those companies that were emerging, they were looking at a merger and acquisition kind of an outlet, which actually resulted in fewer jobs.

And so the effort that we did in a bipartisan way to put the IPO on-ramp together out of the work that Treasury had done I think has produced some pretty good results and the facts speak for themselves.

We heard the argument from BIO a while ago that biotech and pharmaceutical-type companies, research companies take a longer time to develop and therefore need a longer on-ramp. And I think that is part of the reason for the bill that is before us that Ms. Sinema and others have cosponsored.

Is there any concern? Originally when we had that testimony a year or so ago, I was interested in providing an extension of that on-ramp to bio-type companies. This would just do it to any company that fits the definition, an emerging growth company as defined by the original JOBS Act, and then had the limitations of size as part of the bill.

Should we look at limiting it further to the kinds of companies, Mr. Hahn, like yours, or not?

Maybe Mr. Quaadman could answer this more generally?

Mr. HAHN. In the last 18 or last 20 years, I have been in early-stage startup companies. And I have been in manufacturing, IT, and I have been in life sciences now since 2002. I would say, every one of those industries, every one of those companies, I think this is beneficial across-the-board.

Mr. CARNEY. Okay, good. So the other issue that we struggled with when we did the initial IPO ramp bill, and Mr. Himes was arguing that maybe the size limitations were too big, does anybody have—is there any concern, I guess from Mr. Carcello, about the definition of emerging growth companies under that piece of legislation, that it ought to be more limited, or anybody on the panel?

Mr. CARCELLO. It is certainly significantly more limited than the bill you considered last year. So if you are going to move forward, I think the way you have structured it now is certainly less risky to the market than the bill that was voted down last year.

Mr. CARNEY. Okay, thank you.

So Mr. Quaadman, I didn't catch everything that you said about the small-business advocate bill, but there was some recommendation for a change that you mentioned. Could you restate?

Mr. QUAADMAN. Sure. I appreciate your work on the bill. And as I said, we support it.

The SEC has a tripartite mission, right: investor protection; capital formation; and competition. And your bill addresses capital formation and competition.

The two changes we recommended were: one, that the investor advocate and the small-business advocate be on the same plane, so that there should be an amendment that the small-business advocate would have a similar right to appoint a nonvoting member to the Investor Advisory Committee as the investor advocate has with the Small Business Capital Formation Committee. That is one.

Number two, and this has been a longstanding position that we have advocated for, is that these types of advisory committees, and I would say for the Small Business Capital Formation Committee as well as for the Investor Advisory Committee, that they be subject, that they be under the jurisdiction of the Federal Advisory Committee Act so that there is transparency with the proceedings, so that neither the Investor Advisory Committee nor the Small Business Committee could be a quasi-lobbying group that Mr. Carcello says.

Mr. CARNEY. I am running out of time, but I just want to make a comment about that. To us, those of us who are sponsoring the bill and supporting it, we think advocacy, for some, advocacy is lobbying. We think it is advocacy and it is appropriate in this context.

We do this in all kinds of different ways for small businesses at State, local, and Federal Government. We think it is appropriate in this context.

And I want to thank everybody again for being here today and for your comments and input.

Chairman GARRETT. Thank you. And the gentleman yields back.

Mr. Schweikert is recognized for 5 minutes.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

Mr. Hahn, you were kind enough in your testimony, in your written testimony to talk a bit about some of the successes and some of what was helpful in the JOBS Act.

First off, thank you from many of us who cared a lot about that. But just for curiosity, what would you add? What would you change? And what other legislation—the legislation we are talking about here today, do you think it enhances both your success and your use of the JOBS Act?

Mr. HAHN. Thank you. As I stated, the test-the-waters meeting provision of the JOBS Act was great. It takes investors some time to understand our technology and our science and what we are doing.

I think the Fostering Innovation Act takes a targeted approach to build onto the JOBS Act from the 404(b) exemption. So for the first 5 years, we are 404(b) exempt. And the company, GlycoMimetics, has been around since 2003. So here we are in 2015 and we still don't have—we are still several years out from a product to market and product revenue.

So we are going to be in year 6 and we have most of our expenses, our top three expenses, are our payroll, our clinical trials supplies, and clinical trial expenses.

So I think in year 6, we are looking to add upwards of $350,000 in 404(b) attestation and we are still going to be 40 employees, I am still going to have a staff of 3, we are still going to have vanilla financials.

Mr. SCHWEIKERT. Let me ask, within your specialty, how common is this, particularly in biotech, research-intensive sort of new intellectual capital to have as long an on-ramp as you are having?

Mr. HAHN. Very common, very common. It takes upwards of $2 million and anywhere up to 10-plus years to get a product from concept to FDA approval.

Mr. SCHWEIKERT. Okay. And do you think we are going far enough on these pieces of legislation to give you that window to tell

your story, but also to have the capital without the, shall we say, auxiliary expenses?

Mr. HAHN. I think it is a good, measured, targeted next step. So the first 5 years, I think, a lot of companies, we are in that stage now where hopefully we can get to years 6 through 10 and see how that works out. And then possibly expand more and measure it.

Mr. SCHWEIKERT. Thank you.

Mr. Quaadman, in that same sort of realm of subject, I am sort of doing a broad brush of, okay, here is our—we will call our success from a couple of years ago the JOBS Act, here we are doing some very small, incremental touches and improvements, may be able to have some voices, some other paths if you hit the wall of regulatory or litigation. What else would you add? What are we failing to even engage in the conversation on?

Mr. QUAADMAN. First off, I think both the Small Business Advocate bill as well as Mr. Poliquin's draft bill go a long—those bills, if they are implemented, will have far-ranging consequences because we will actually start to have a real debate about capital formation and competition within the SEC.

Mr. SCHWEIKERT. Okay. But first on the Poliquin bill, and I think we are still just in draft or discussion draft at this point?

Mr. POLIQUIN. Yes.

Mr. SCHWEIKERT. Does it actually provide the path that you believe is necessary?

Mr. QUAADMAN. Yes, because what you are doing is you are creating a mechanism that the Commission actually has to respond to recommendations. Because remember, the JOBS Act was a series of recommendations that advisory committees and the SEC had been making for years and nothing had ever happened. So rather than things just going over the transom and being ignored, this actually starts to force mechanisms for something to happen.

So I think it is also important, for it allows the SEC to take the self-initiative to try and keep up with the markets rather than having Congress having to bear down on them.

Mr. SCHWEIKERT. Okay, sort of the second half of this, and I don't mean to get ethereal. With what I am seeing in much of the capital formation marketplace, we all see the numbers that today we have, what, a third, or 40 percent fewer publicly traded companies, but we see the movement in private equity, we see the movement now on versions of capital raises that are happening online.

Are we being robust enough in understanding that the way we raise capital today, but over the next decade, is going to look really different than it did last decade?

Mr. QUAADMAN. The capital markets are always evolving. So I can guarantee you that 10 years from now, it is going to be much different than it is today. Remember, we are seeing online lending start to ramp up.

Mr. SCHWEIKERT. Yes, peer-to-peer, the Lending Club models are exploding.

Mr. QUAADMAN. Yes.

Mr. SCHWEIKERT. But are we being sort of future-proof in the designs of how we are addressing this? And are we being prescriptive enough to the SEC?

And I know, Mr. Chairman, thank you for your patience.

But for many of us, we sat here for 3 years waiting for the rule sets on crowdfunding we all thought was going to be pretty simple. So asking the SEC to promulgate rule sets has become a disaster. And we almost have to be prescriptive in what we do, which also means we have to get it right.

Mr. QUAADMAN. Yes. The one other thing that I would mention that should occur is also, what are the policies and regulations that are driving public companies out of that space? So what is the outflow problem? And I don't think we have really addressed that one.

Mr. SCHWEIKERT. Okay.

Mr. Chairman, thank you for your patience.

Chairman GARRETT. Thank you. The gentleman's time has expired.

The gentleman from California is welcome and recognized for 5 minutes.

Mr. SHERMAN. Thank you. I think it is critical that we get capital to small business. Outside the scope of this hearing, most businesses borrow most of their capital. And what I am seeing is that if you are borrowing money at prime-plus-3, you can get the money. If you want to borrow money at 33 percent annual, well, there is an advertisement every few minutes about how you get your money the next day.

But the prime-plus-6, prime-plus-8 loan, prime-plus-5 loan that I was used to seeing when banks and other lenders took some limited risk seems to be gone. But here we are focused on capital and shareholders' equity rather than loans.

Mr. Carcello, beyond the JOBS Act, what proposals can you come up with that will help small and medium-sized businesses get access to equity capital?

And perhaps others would have a comment as well.

Mr. CARCELLO. I initially thought, as I read through these bills, that the HALOS Act was good. And so this gives me an opportunity to talk about that Act. And as these panelists have talked about it, they have focused on angel investor groups, and I actually think those are quite good and quite helpful, and I think would be bipartisan.

What threw me when I read that Act, though, is the expansion of that Act into venues such as not-for-profits and universities and governmental entities. And for someone who has worked in a university for over 25 years, I can tell you most people who work there are not accredited investors, most people who work there are not sophisticated investors. And I think that poses tremendous pressure.

Mr. SHERMAN. You mean my professors were not as smart as they told me they were?

[laughter]

Go on.

Mr. CARCELLO. Not about financial matters. Most Americans, as you probably know, Mr. Sherman, being a CPA, are not quite knowledgeable about financial matters.

Mr. SHERMAN. Does anyone else have a comment? If not, I will move on to the next question.

Mr. Quaadman, I am a cosponsor of the SEC Small Business Advocacy Act, which would create an Office of Advocate for Small

Business Capital Formation. Do you think this new office would help energize the capital markets for small and medium size in initial public offering companies?

Mr. QUAADMAN. Yes, I think it would allow for that voice for capital formation to be heard within the halls of the SEC where it hasn't been before. And as I said before, I think it would also force the SEC to modernize rules that would prevent Congress from having to go through a JOBS Act exercise again.

Mr. SHERMAN. Dr. Carcello, should we be providing additional exemptions from Section 404, I believe it is 404(b), dealing with reporting on a company's internal controls? I know this is a cost for some companies and it seems like an unwarranted cost except when it discloses a problem.

Mr. CARCELLO. Right. Yes, I don't think we should. I think if the Congress decides to move forward, as I suggested to the committee, I would at least give the investors, the owners of the company, the right to elect. So at the end of 5 years, put it to a vote, put it to a shareholder vote. And if it is as good an idea as all of the people to my left and right think it is, then the shareholders will overwhelmingly approve it.

I do think that 404 has produced tremendous benefits. There is a lot of research, not just in the academy. The Financial Executives Research Foundation recently released a study where financial executives, approximately half of them, have said the benefits of the internal control attestation far exceed the costs.

Again, it was put in place because of problems with financial reporting, restatements, fraud. And when that happens, confidence in the capital markets evaporates and capital dries up. So if we are concerned about capital formation, don't lose sight of that other side.

And if you would give me the ability, I want to make a very small comment, if I could, about the Small Business Advocate Act. I think it is important—

Mr. SHERMAN. I do want to. I have just a few more seconds and it wouldn't be a committee hearing if I didn't rail about the Financial Accounting Standards Board (FASB) and their decision to put $2 trillion on the balance sheet of businesses, chiefly small and medium-sized businesses.

Mr. Quaadman and I have been trying to prevent this unwarranted damage to our business system. And members of the subcommittee should be aware that the FASB has said they are going to go forward with this with virtually no input from any part of the public that isn't already in their own Rolodex.

And it is just illustrative of the fact that we should never have that much governmental power located in Norwalk, Connecticut.

I yield back.

Chairman GARRETT. Thank you. The gentleman yields back.

The gentleman from Maine is recognized for 5 minutes.

Mr. POLIQUIN. Thank you, Mr. Chairman. I appreciate it very much.

When we have an opportunity to get government together with the business community, the folks who are on the ground, growing their companies and creating jobs, it is a better time and a better place for all Americans and all job creators.

That is why I am excited about discussing with you your experience when it comes to the small business capital formation forums that the SEC has been having over the past 35 years.

Now, it is my opinion if we are going to get all this talent together, folks who are taking time out from running their businesses to try to inform government officials, in particular in this case the SEC, on the best way to allow small companies to borrow money and grow and hire more individuals and grow the economy, then we should listen to the results they come up with.

Now, what I would like to do is start with you, Mr. Hahn. I believe that you were not or have not participated specifically in these business-government forums that the SEC has been holding the last 35 years, but you represent folks who do.

And could you, to the best of your ability, inform all of us here on this committee and the public as to what experience your folks have had with respect to this forum? Have the recommendations been useful?

Mr. HAHN. I think from my understanding, as I said earlier, a lot of—the SEC often doesn't act on the recommendations of the advisory committee and the Government-Business Forum. However, they are published. I think it was Congress that took parts of the JOBS Act out of those recommendations—

Mr. POLIQUIN. Right.

Mr. HAHN. —which was a tremendous success.

Mr. POLIQUIN. So these specific recommendations from past forums ended up in legislation that was passed through this committee. Correct?

Mr. HAHN. Yes.

Mr. POLIQUIN. So it was pretty useful.

Mr. HAHN. Very useful.

Mr. POLIQUIN. Okay. And doesn't it therefore make sense that not just that one example in the JOBS Act, but on an ongoing basis we have the body, the SEC, that is holding these and organizing these forums to make sure that every recommendation that comes out of these forums they address, they comment on in a public format. And if they are going to adopt some of the recommendations, fine. And if not, why? Doesn't that make sense?

Mr. HAHN. Total sense.

Mr. POLIQUIN. And that would be helpful to those in this space to make sure they know what rules coming down the pike might affect them when it comes to raising money for their companies.

Mr. HAHN. Also, it makes you wonder what else has been missed.

Mr. POLIQUIN. Say that one more time.

Mr. HAHN. It also makes you wonder what has been missed, what hasn't come out of those recommendations that could be helping businesses like mine.

Mr. POLIQUIN. Absolutely. I was about to morph into that.

And Mr. Mathieu, maybe you can comment on this. If you have 35 years of forums that are coming up with all of these experts from their field, in government, in academia, attorneys even, that are coming up with these ideas, doesn't it make sense that if you publicly come out and you comment on each of these recommendations, then you don't have to start over the next year?

You now have a wealth of information, a database of recommendations that might make sense going forward such that we can go forward instead of repeating what we have just done the last few years.

Mr. MATHIEU. That completely makes sense. First, thanks for introducing the legislation.

Mr. POLIQUIN. You bet.

Mr. MATHIEU. It is very important. What is crazy about this is that, as you said, there are a lot of people who spend a lot of time preparing for those forums, the structure makes a lot of sense, it gets a lot of people, thoughtful-thinking people into group sessions, breakout sessions where they are really spending a lot of their emotion and mental efforts to come up with really great ideas to help small business.

They put them in a package, they come up with the idea, and then it just goes nowhere.

Mr. POLIQUIN. It sits on the shelf.

Mr. MATHIEU. It goes into the atmosphere, which is just crazy. That is like, have every small business spend a week-and-a-half doing business development or strategic planning and then throw it in the trash and the shredder right after they have finished it. It doesn't make sense.

Mr. POLIQUIN. Yes. We have a fellow named Tom Coyte from Atlantic Financial in Maine who runs a VC shop, who came down and participated in some of these forums. So, it is close to our heart.

Mr. Quaadman, if I could end with you, I just have a short amount of time here. Doesn't it make sense to also require the SEC to not only participate in these forums, but make sure that their recommendations are not only public, but they are relevant to the dynamic nature of our markets?

One of the great things about our economy and why it has been so strong for so long, notwithstanding the recent period of time we are going through, is that we have a dynamic and growing, evolving and creative capital markets system, the envy of the world.

These regulations should evolve along with our capital markets, shouldn't they?

Mr. QUAADMAN. Yes. And I agree with all the other comments that were said. The other thing I would say too, and the reason why it is important for the SEC to be a part of that and to respond to it is because it should also focus them on areas where they are not looking and where they should be looking. So, I think there is a win-win here.

Mr. POLIQUIN. I thank all of you gentlemen very much for participating. I appreciate it very much.

Thank you, Mr. Chairman. I yield back my time.

Chairman GARRETT. The gentleman's time has expired.

Mr. Ellison, for 5 minutes, if he is—

Mr. ELLISON. Thank you, Mr. Chairman, and the ranking member. I appreciate the recognition.

Professor Carcello, thank you for your service on the Securities and Exchange Commission's Investor Advisory Board. I do appreciate it.

Anyone following the Presidential election knows that many people think that the rules are rigged in favor of powerful companies.

H.R. 3798 seems to further rig this, in my view, by allowing big companies, the defendants, to pick a more favorable venue for investigations into their alleged misconduct.

The SEC now chooses a venue for enforcement that serves the interests of investors and the public, yet this bill would allow a well-funded defendant to choose a district court venue. We know that district courts are often overwhelmed, so this type of forum shopping may delay trial for up to a decade in some cases.

How is allowing a defendant to essentially forum shop in the public interest?

Mr. CARCELLO. Yes, I am not convinced it is in the public interest. And here is a thought experiment for the committee. Imagine if 15 years ago, the SEC thought there was a problem with Bernie Madoff, and they brought it in Federal court because they were forced to as a result of this, and there was a long delay. And during that time, he continued to collect money and ruin people's lives. Does this committee really want that obligation on their head?

Mr. ELLISON. Dr. Carcello, I think I can say on behalf of all of my colleagues on both sides of the aisle, no. So I think we should take steps to address it.

When you served on the Investor Advisory Committee, one of the areas the committee considered was the prevalence of contracts and bylaws that contained mandatory arbitration clauses. In fact, Commissioner Aguilar called to end mandatory arbitration.

I wonder what your views are on the issue of, say, this committee bringing a bill to allow defendants to choose the venue of the enforcement action while not allowing investors the same option.

Mr. CARCELLO. Not just investors, Congressman Ellison. How about every person in the United States? There was a powerful series of stories by The New York Times about a month ago that everyone should read, about how the United States has essentially become a land where every citizen in this country, all of your constituents are routinely every day signing away their rights to jury trials in employment, in consumer purchases, in virtually every sphere of their life. And there is no outrage about that, but there is outrage about due process for largely well-monied financial professionals.

It is far from clear to me, and I think it would be far from clear to most people in the United States, why that is in the interests of the republic.

Mr. ELLISON. I actually have a bill called the Investor Choice Act, H.R. 1098, that would prohibit predispute mandatory arbitration clauses in investment contracts. I urge all my colleagues to sign it.

But if I may just ask you a few more questions. In your testimony you detail a number of concerns with both small-business bills we are considering today. One of your concerns is that H.R. 3784 requires redundant authority. And I will just quote your testimony, the Small Business Advisory Committees, "create a quasi-lobbying group to seek a more favorable regulatory climate for small businesses. This may succeed in reducing the costs of regulation, but at the potential cost of greater information risk to investors."

You note the advisory committee created a rigged system that lacks ideological balance and seems gerrymandered. If Congress mandated the Small Business Advisory Committee, should it require that investor and public interests are represented and have voting powers? And can you give us a few ideas to make it less of a quasi-lobbying group?

Mr. CARCELLO. Exactly. That is exactly right. The IAC, which this is arguably patterned against, has—as I said earlier, five Commissioners have four picks. Look at this committee. Professor Grundfest is here representing the Republicans; I am here representing the Democrats. We are both on the IAC.

The SEC is highly split, so the 20 members on the IAC bring an ideological diversity to our discussions. It forces us to seek consensus solutions.

If you look at the proposed Small Business Advisory Committee, it is essentially officers, directors, advisers, and investors, which sounds good until you realize it is venture capital, largely, which are heavily owners in that company with a different stake than the kind of mom-and-pop retail investor, and it is not at all comparable to the IAC.

So if you are going to move forward with that group, first of all, I think one thing that should be thought about, Congressman Ellison, there is this implicit undertone here that investors are one constituency and small business is another. Why don't we have an advisory committee for midsize business and large business and biotech businesses?

Investors are every single adult in this country.

Chairman GARRETT. The gentleman's time is way over.

Mr. ELLISON. Thank you so much, sir.

Chairman GARRETT. Mr. Huizenga is recognized for 5 minutes.

Mr. HUIZENGA. Thank you, Mr. Chairman.

And I will turn to you, Mr. Grundfest. Do you care to comment on that riff that we just heard? I would love to hear from you.

Mr. GRUNDFEST. Yes. Just one simple point, in terms of point of accuracy. I think many of the issues that we are dealing with today aren't Democratic or Republican issues. Not that it means anything; I am a registered Democrat, and have always been a registered Democrat, and I don't view myself as being here representing the Republican side or the Democratic side.

I think there are fundamental questions of fairness about how the process is actually operated. I agree with Mr. Ellison that fairness is an issue that needs to be considered for all people in all forums of all proceedings.

Fairness can be in the eye of the beholder. That is why I go back to that one word that I think is the focus of my testimony. The question is, how do we achieve an appropriate balance? Clearly, there are situations where investors' rights and the SEC's rights need to be very aggressively protected.

But by the same token, you can't have a situation where I think the SEC acts as judge and jury and as summary prosecutor and eliminates the rights of everyone else involved in the process.

It is a difficult question. Let us admit that it is a difficult question. But let us not try to polarize the issues more than they already are.

Mr. HUIZENGA. I appreciate that.

Mr. Hahn, I want to quickly turn to you. The Fostering Innovation Act and the high costs associated with the SOX 404(b) compliance has been cited repeatedly by small and emerging companies as one of the deterrents from listing in the U.S. public markets. I wanted to get your comment on that.

And then also regarding Sarbanes-Oxley, obviously, that is an admirable goal to protect investors. However, many argue that the cost of Section 404(b) far outweighs any perceived benefit for most small, public companies. You suggest in your testimony that investors in biotech companies do not list 404(b) compliance as a top priority of their own due diligence. Could you describe what types of information are used by investors and people looking at that?

So if you want to touch on the 404(b), and then give me a profile.

Mr. HAHN. On the 404(b) side, I think it is important to note that just because we are 404(b) exempt currently, we do have a strong internal control framework in place and we do have an outside party that audits our controls and reports directly to the Audit Committee.

I spend maybe $15,000 a year on that. As the current now in year 6 when I have to be 404(b) compliant, my expenses in that go to $350,000 and nothing is going to change from our business from year 5 to year 6. We are still going to have 40 employees, I still have a staff of three. So that is kind of the impact on the 404(b) side.

As it relates—I'm sorry, what was the second part of your question?

Mr. HUIZENGA. Yes, just, if they are not looking at 404(b), what type of information are investors in small biotech companies looking at?

Mr. HAHN. As I stated earlier, for the test-the-waters IPO, we met with 90-plus investors. And since we have been public in January of 2014, we have met with approximately 130 more investors. So about 220 one-on-one investor meetings in about the last 2½ years. All of the questions around understanding our technology, our science, the indications that we are going after in our current clinical trials. I think the only financial-related questions I get are, what is your cash balance and what is your runway, and how long is that going to get you? The only questions, no other financial questions that way.

Mr. HUIZENGA. Okay. So is that information not useful or is it just not relevant really to the biotech space?

Mr. HAHN. It is not, I would say, it is not relevant, not primarily relevant to the investors. It is a secondary issue. They want to understand the science and the technology and they want to know that we are spending our resources and our money on the R&D side and not on the administrative side.

Mr. HUIZENGA. All right.

Mr. Quaadman, you said something that I don't even remember how many speakers ago it was or questioners ago, but the outflow problem on businesses, and I want to give you the last little bit here to talk about that problem, because I am very concerned about that as well.

Mr. QUAADMAN. Sure. We have half as many public companies in the United States as we did in 1995. The number of public companies has gone down every year, for 19 of the last 20 years. Clearly, something is wrong and something is broken.

Mr. HUIZENGA. Isn't it just a bad economy? That is what we hear.

Mr. QUAADMAN. No. Remember, 1995, 1996, 1997, those were awfully good years and that is when the decline started, right? So we have to really match up our policies with capital formation.

Two other points I just want to quickly mention. To Professor Carcello's notion of, let's put this out for a shareholder proposal, 54 percent of institutional investors say our current corporate disclosures are too voluminous and don't provide relevant information.

Mr. HUIZENGA. In other words, sometimes too much information really doesn't give you any information.

Mr. QUAADMAN. Correct. So you know what? Let's crank up the shareholder proposals because that will be faster than the SEC with the disclosure effectiveness project.

Secondly, what we really have to also pay attention to while we are looking at these issues is that Europe is trying to replicate what we are doing. So we should also remember that as well.

Chairman GARRETT. Thank you.

Mr. HUIZENGA. Thank you, my time has expired.

Chairman GARRETT. The gentleman's time has expired.

Mr. Green, you are recognized for the next-to-the-last word.

Mr. GREEN. Thank you, Mr. Chairman.

And I thank the witnesses for appearing today.

I am exceedingly concerned about the conflating of criminal and civil law today. Whether by accident or design, this seems to have taken place. All of you are scholarly people and you know that out of the same set of circumstances, you can have a criminal case or you can have a civil case.

And in a criminal case, the standard of proof is guilt beyond a reasonable doubt, the doubt in the mind of a reasonable person. If it exists, then you must say by your verdict, "not guilty."

In a civil case, generally speaking, most of the time it is preponderance of the evidence, the greater weight and degree of credible testimony.

If you differ with what I have just said, will you kindly raise your hand? Let the record show that no one differs.

And it is also true that these hearings with the SEC actually go before an independent arbiter known as an administrative law judge? And the administrative law judge makes a finding of facts and issues and also conclusions of law?

If you differ with what I have just said, raise your hand. How do you differ, sir?

Mr. QUAADMAN. The administrative law judge is an employee of the SEC; they are not independent.

Mr. GREEN. If this is the case, the judge who hears my case in court, who also hears my motion for a new trial, is it inappropriate for that to happen, to take place?

Mr. QUAADMAN. No, what the point here is, and I think Mr. Duffy was making this point earlier, if we were to look at it in that

way, the district attorney would also be the judge. And that is currently—

Mr. GREEN. I am pleased that you said that because it has been my experience that most judges are former DAs.

If you differ with what I have just said, raise your hand.

The point to be made is this. If you are talking about preponderance of the evidence in a civil case that can be appealed to the Commission, correct, and then from the Commission to a Federal judge, why would you have clear and convincing evidence as a standard at the administrative hearing and then when you go to the Federal judge you have preponderance of the evidence?

Do you agree that can occur? If no one agrees, then I will have to make the case again. Do you agree that can occur? If you have preponderance of the evidence in the Federal district court, and you have clear and convincing evidence before an administrative law judge, you now have the same set of facts, two arbiters, different standards of proof.

Mr. Carcello, do you agree?

Mr. CARCELLO. Yes.

Mr. GREEN. Okay. Let us find someone who differs. Who differs? Who differs that we would have two standards of proof with the same set of facts?

Mr. QUAADMAN. Mr. Green, as I mentioned in my opening statement—

Mr. GREEN. Would you kindly do this? Would you start with yes, I agree, or no, I don't agree? Because sometimes when people finish, I don't know whether they have said yes or no.

Mr. QUAADMAN. No. We had suggested an amendment to the bill that there be one standard of evidence.

Mr. GREEN. So you agree with what I have said. The question is, do you agree with what I have just said? You agree. So if you agree with what I have just said, and you understand the difference between criminal and civil law, O.J. not guilty criminal case, O.J. guilty civil case, these things exist and they have been decided clearly by Federal courts that they are constitutional. There is no unconstitutionality here.

And I would also add this. To say, to use terminology of finding a person guilty before an administrative law judge, now, you heard that said earlier. Why would a professor of law not correct that in the record? The administrative law judge doesn't find anyone guilty or any corporation guilty.

If you differ with what I have just said, raise your hand. Let the record reflect that nobody differs.

Dear friends, we have to take these issues seriously when we are talking about changing the laws that impact not only corporate America, but also the citizens of the United States of America. Investors are citizens. They are taxpayers. They deserve fairness, too.

Bernie Madoff treated a lot of investors unfairly. And but for the SEC's ability to go before an administrative law judge, I am not sure how that would have ultimately ended.

So I thank you for your time, Mr. Chairman, and I yield back.

Chairman GARRETT. The gentleman yields back.

Mr. Hill is recognized for 5 minutes.

Mr. HILL. Thank you, Mr. Chairman.

And I appreciate the witnesses' forbearance today.

I think I want to start out and continue on that theme.

And Mr. Quaadman, if you would just, I think, for the committee state the difference between mandatory arbitration and the SEC administrative proceedings. Because having been in the brokerage business for many years, we have had mandatory arbitration and it has worked, I think, very effectively. Fifty percent of those cases tend to reach a conclusion before they even go to a hearing panel.

But I think we ought to clarify the difference between these two.

Mr. QUAADMAN. These are two completely different things. And we are talking about two completely different universes.

Mandatory arbitration deals with two private entities engaged in a transaction, and they go before a neutral third party if there is a dispute. That actually has been a system which has worked very well with keeping cases out of the courts, which people have talked about overburdened court dockets.

What we are dealing with here, with administrative proceedings with the SEC, is we are actually having the government prosecute, whether or not we want to talk about whether it is civil or criminal, but there are prosecutions that will destroy a person's career. So these are completely different items altogether.

Mr. HILL. Thank you. I appreciate that clarification for the record today.

I have spent a lot of my career in private placements for small business. And so I appreciate the effort of my colleagues on this subject. And I have also on and off been involved in small-cap public companies and I know about the cost of trying to manage small-cap enterprises.

One concern I have always had is this quarterly cost to be public. And many years ago, I was associated with a company with a market cap of around $70 million and around $10 or $12 million in EBITDA. And if my memory is right, and I am going from memory, I didn't prepare for this conversation, it was about $400,000 a quarter to do a Q and K prep and internal control work and that kind of thing. This is both the audit fee as well as the preparation-type costs. And that is substantial.

So anything that affects costs, I think is one of the barriers to Mr. Quaadman's talk about why we have declining numbers of IPO companies, despite efforts in recent years to reverse that trend.

Section 404, what is a way to, in my view, look at the marginal difference in 404? In other words, sure, there is some benefit by having a robust internal control system. But haven't we gone overboard in the prescriptive nature of it and perhaps the costs really do outweigh the benefits, particularly for small, simple businesses where they are really being held to a 404(b) standard that goes a lot deeper than you would have to do in a simple, straightforward business?

Mr. Hahn, do you want to start out on that? Because I know you are preparing essentially for this feature.

Mr. HAHN. I have been involved in four startup companies and implemented the accounting systems and the process and procedures. And every one of those, as I have learned over the last 18 years, is measured controls, appropriate controls measured that are appropriate to the business and the business processes.

If you put too many controls on, you just clamp down the business and people can't operate.

I think the 404(b) should take that same approach where we are exempt now, but it seems that this one-size-fits-all; that we are held to the same standards as these large corporations, we have a $130 million market cap, we cut 125 checks a month, we have two check signers. So to hold us to the same standards as these large corporations, I just don't feel is appropriate.

Mr. HILL. It is like in the bank regulatory environment where we are all held to a high IT standard for data security in commercial banks. Some banks are more simple than others, but the regulation is written the same for Citibank's IT protocol as for a small community bank.

And I think 404(b) over the years, because the accounting industry wants to be conservative in their approach, they have to be certified, they have to be peek-a-boo licensed, and so they don't make a distinction perhaps enough, I think, for small businesses.

Any comments on the crowdfunding proposal? In my seconds left, who wants to tackle the comments on the SEC's crowdfunding proposal? Does anybody have any thoughts on that? It just got published in the last couple of weeks.

Mr. QUAADMAN. I think we are going to have to see how that is going to progress. I think that has been an innovative portion of the JOBS Act. We have argued for strong internal controls. I know Europe is trying to do some similar things.

So I think that is something where we had also called for, as we did with the HALOS Act, a retrospective review after a couple of years to see how it is working and what needs to happen to make it better.

Mr. HILL. Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. The gentleman yields back.

This brings us to the end. But since one of the Members raised a point, and I will yield to you another minute if you want, but just to clarify a point since I think he was referring to me when I used the term "guilt" or not.

I will just ask Mr. Quaadman for 1 minute the question, is this a case where there is a distinction without a difference? Truly, there is a difference between a criminal and a civil matter, but as far as the ability of the SEC to impose a fine or require restitution or to require that you lose your license, is that a distinction without a difference? Because you can basically devastate an individual, take all his livelihood away and take all of his assets away by an SEC enforcement action.

Mr. QUAADMAN. That is correct. And not only have we seen APs change in the way that they are used, but the way that the civil tools are used, they are now quasi-criminal trials and cases. So I think we can quibble, but I think you are exactly right. We are talking about a distinction without a difference.

Chairman GARRETT. And since I went over our time, does Mr. Carney have anything else for another minute?

Mr. CARNEY. Yes. I would just like to take a minute again to go back to the characterization, which I think is troubling to hear the small-business advocate referred to as a lobbying kind of thing.

The thing that I hear most from my business constituents, large businesses and small businesses, is that there is no advocate, there is no voice for small businesses in a lot of administrative procedures.

My history is more at the State and local government level. And many of these big bureaucracies that we deal with here in Washington, it is an entirely different thing. And maybe it is that our politics are so poisoned by that word being such a negative thing.

But the essence of the bill is to bring small-business concerns, which are varied and different, to the SEC in their processes to facilitate policies and regulations that don't hurt small businesses and capital formation.

I think some of the work that has been done through the JOBS Act, again, my effort was with Mr. Fincher on the IP on-ramp as the attempt is to get beyond characterizations that are pejorative or whatever in such a way to try to move the ball so that we do do something that makes it more beneficial for a company to be a public company, for companies in particular to be incorporated in the great State of Delaware, and not to get in these political battles back and forth.

That is not to diminish the concerns, Dr. Carcello, that you have. I acknowledge those, and I will look at those in relationship to the legislation.

But if we are going to make progress, I think we have to think about the language that we use as we characterize these things.

Mr. Chairman, thank you, and I yield back.

Chairman GARRETT. Thank you.

I thank the panel, all of our witnesses here today, for your written testimony and also for your testimony today and your questions as well.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And with that, without objection, this hearing is adjourned.

[Whereupon, at 12:00 p.m., the hearing was adjourned.]

A P P E N D I X

December 2, 2015

Statement of Joseph V. Carcello, Ph.D., CPA, CGMA, CMA, CIA
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Written Statement in Support of my Testimony before the Capital Markets and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee on "Legislative Proposals to Improve the U.S. Capital Markets"

I have served as a professor at the University of Tennessee for over 20 years, where I teach accounting, auditing, and corporate governance. In addition to my teaching and research, my remarks are informed by my service on the Securities and Exchange Commission's Investor Advisory Committee, an outside advisory group to the Commission which was statutorily-created as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), and the PCAOB's Investor Advisory Group, which is an outside advisory group to the PCAOB.

I address each of the five legislative proposals that would affect the U.S. capital markets.

SEC Small Business Advocate Act (HR 3784) and Small Business Capital Formation Enhancement Act (not yet numbered)

HR 3784 would establish an Advocate for Small Business Capital Formation within the Securities and Exchange Commission (SEC). In addition, HR 3784 would establish within the SEC the Small Business Capital Formation Advisory Committee. It would appear that HR 3784 is modeled after Section 915 of the Dodd-Frank Act where the SEC's Office of the Investor Advocate was established, and Section 911 of Dodd-Frank which established the SEC Investor Advisory Committee. As a member of the SEC Investor Advisory Committee, and one who interacts with the SEC's Office of the Investor Advocate, I am well positioned to comment on these bills.

A threshold question that Congress needs to answer is whether the interests of small businesses fail to be heard by either Congress or the SEC – that is, what is the problem that this bill is proposing to solve. One can only surmise that the problem is a lack of access to Congress or the SEC and/or the failure of these entities to be responsive to the needs of small businesses. On either dimension, the facts belie the existence of a problem. For example, the Dodd-Frank Act permanently exempted smaller public companies from complying with Section 404(b) of the Sarbanes-Oxley Act, and the Jumpstart Our Business Startups Act (JOBS Act) made numerous changes to facilitate capital formation by smaller businesses and the SEC has effectively

implemented many of the JOBS Act provisions. Moreover, the SEC already maintains an Office of Small Business Policy within the Division of Corporation Finance which, among other activities, coordinates the annual SEC Government-Business Forum on Small Business Capital Formation. Furthermore, the SEC currently maintains an Advisory Committee on Small and Emerging Companies. The Congressional record needs to clearly document the inability of small businesses to seek effective redress of problems through Congress and the SEC, and further indicate why the existing institutional mechanisms – the SEC's Office of Small Business Policy, the SEC Government-Business Forum on Small Business Capital Formation, and the SEC's Advisory Committee on Small and Emerging Companies -- are not adequate to address any problems that might exist.

Assuming that the existence of a problem can be documented, I then turn to problems with the bill as currently drafted. Given the language in HR 3784, the composition of the Small Business Capital Formation Advisory Committee is likely to result in the group essentially be a lobbying group for small businesses – a lobbying group that Congress would have granted a government imprimatur to. The contemplated composition of this advisory committee is officers and directors of smaller companies, professional advisors to these companies, and a very narrow slice of investors in these companies (e.g., angel capital investors, venture capital funds, and private offices). Arguably, the bill contemplates a representative of the broader investor population (appointed by the SEC's Investor Advocate) and a representative of the public interest (appointed by the North American Securities Administrators Association). Interestingly, and problematically, these committee members would not have a vote. Sort of like gerrymandering the composition of a committee. Let's contrast this structure with how members of the SEC Investor Advisory Committee are chosen – the IAC includes representatives of industry participants, investors (including public pension funds, union funds, hedge funds, venture capital firms), investor advocates, academics with widely varying ideological views, regulators, among others. Interestingly, and noteworthy, is that two of the IAC's members are on this panel – testifying for different sides related to these bills. As such, the IAC is essentially ideologically balanced, as each of the five SEC commissioners have four selections. Conversely, the proposed Small Business Capital Formation Advisory Committee would appear unlikely to achieve such ideological balance.

Finally, HR 3784, as well as a number of the other bills being discussed this morning, seem to view any shortfall of capital experienced by small businesses as a problem of demand. That is, small businesses lack capital because these businesses won't seek capital in the public markets due to onerous and high cost regulation. Leaving aside the veracity of this viewpoint, this argument ignores the suppliers of capital – investors. Creating a quasi-lobbying group to seek a more favorable regulatory climate for small businesses may succeed in reducing the cost of regulation, but at the potential cost of greater information risk to investors – less transparent disclosures, a higher incidence of non-GAAP reporting as evidenced through restatements and,

in the extreme, a higher incidence of financial fraud. Such an outcome would actually be counter-productive for small businesses, as capital would either exit the market or would only be available at a much higher cost of capital. Not only would investors not be protected, but capital formation would be impeded rather than enhanced. The optimal regulatory strategy is to balance the costs of regulation against the benefits of regulation, and it seems unlikely that recommendations from the regulated industry would lead to such an outcome.

The Small Business Capital Formation Enhancement Act is quite brief but would require the SEC to review the findings and recommendations of the Forum on Capital Investment, and to publicly disclose what action the SEC plans to take in response. Again, this recommendation appears to be patterned after the requirements in Section 911 of the Dodd-Frank Act related to recommendations of the SEC's Investor Advisory Committee. But there are important differences. As noted previously, the IAC is ideologically balanced and therefore our recommendations almost always involve compromise and represent a consensus viewpoint. This process is painstaking and time consuming so the IAC has only made a modest number of recommendations in its three years of life. Conversely, any individual participant at the Small Business Forum on Capital Investment can make a recommendation, resulting in the SEC receiving an excessive number of recommendations, some of which may be ill-formed and possibly not within the SEC's purview. Requiring the SEC to respond to every recommendation is inefficient and a poor use of taxpayer resources, particularly given the chronic underfunding of the agency.

Due Process Restoration Act of 2015 (HR 3798)

HR 3798 would essentially do two things. First, it would give defendants subject to SEC proceedings before an Administrative Law Judge (ALJ) the option to have those proceedings terminated. If the SEC wanted to proceed, the Commission would have to bring the charges in U.S. District Court. Second, for those proceedings that were heard before an ALJ the burden of proof would be raised – from today's "preponderance of the evidence" standard to a more difficult hurdle, "clear and convincing evidence". This bill is ostensibly in response to a greater number of SEC enforcement actions being heard before an ALJ, and the SEC's supposedly higher success rate before an ALJ than in U.S. District Court (Eaglesham 2015a).

Before changing the SEC's enforcement process, it is important to remember that Congress is the body that made it easier for the Commission to bring certain enforcement actions before an ALJ. First, in the Sarbanes-Oxley Act (SOX) (2002), Congress, in Section 305 of the Act, authorized the Commission to bar an individual from serving as an officer or director of a public company if the individual is deemed "unfit" to serve in those roles. The previous legal standard was "substantial unfitness". Also, prior to SOX, only a federal court could issue such a bar. SOX authorized the SEC to issue such a bar through proceedings before an ALJ. Second, in the

Dodd-Frank Act (2010), Congress, in Section 929P of the Act, authorized the Commission to impose civil monetary penalties in cease-and-desist proceedings. Presumably Congress included these provisions in SOX and in Dodd-Frank because they were needed – that is, the SEC needed greater enforcement tools to effectively police the capital markets. Before Congress acts to change the enforcement mechanism that it has created, quite recently I would add, Congress needs to first conclude, based on rigorous study and analysis, that a problem exists, and that the proposed remedies would solve the problem and would not create even greater problems as a result of any changes implemented.

First, it is not clear to me that a problem exists. Eaglesham (2015a) reports that the SEC prevailed in approximately 90 percent of the cases it brought before an ALJ between 2010 and March 2015 and in approximately 70 percent of the cases it brought in federal court. The difference between the Commission's 90 percent success rate before an ALJ and 70 percent success rate in federal court is arguably the causative factor behind HR 3798. Eaglesham also reports that the SEC has taken steps to provide greater protections to defendants (2015b), and the Commission is bringing fewer cases before an ALJ (Eaglesham 2015c). Congress should tread carefully before trying to fix a perceived problem where that problem may already be solved. Second, if after study Congress continues to believe that a problem exists, it should not underestimate the collateral damage that may be done by changing the SEC's enforcement powers. Giving defendants the right to effectively choose the venue in which they will be tried is unlikely to be in the best interest of society, and will almost certainly make it more difficult for the SEC to deter and punish securities law violations, including fraud. Individual defendants may benefit, but society as a whole may bear the cost. Such a change can only be justified if Congress believes that the SEC is currently bringing too many enforcement actions. This seems unlikely given the wave of fraudulent financial reporting in the early 2000s, and the almost complete implosion of the financial markets later that same decade. Moreover, defining guilt differently in federal court (i.e., preponderance of the evidence) than before an ALJ (clear and convincing evidence, if HR 3798 is adopted) is likely to cause uncertainty and further litigation. Neither is good for defendants or society.

Finally, some would argue that HR 3798 is needed purely on fairness grounds for the accused. Some in Congress may believe that trying a case before an ALJ gives the SEC a "home court" advantage and that federal court is a more neutral forum. But those in Congress making the case that often monied interests (brokers, financial institutions, corporations, officers and directors, etc.) need more fairness need to contemplate why it is not even more unfair for individual citizens to be forced into binding arbitration (Silver-Greenberg and Gebeloff 2015; Silver-Greenberg and Corkery 2015a and 2015b). Could it be that fairness means one thing when it is pursued by those with money and quite another when it is pursued by ordinary citizens?

Helping Angels Lead Our Startups Act (not yet numbered)

This bill (not yet numbered), hereafter referred to as the HALOS Act, would appear to amend Rule 506 of Regulation D so that the prohibition on general solicitation and general advertising would not apply to sales events (a.k.a., demo days, venture fairs, pitch days) that are sponsored by a governmental entity, a college or university, a nonprofit association, an angel investor group, a trade association, or a venture capital association or forum. Rule 506(c) of Reg. D allows broad solicitation and general advertising but all investors in a 506(c) offering must be accredited and the company must take reasonable steps to verify the investor's accredited status (i.e., self- certification is not sufficient).

In my view, facilitating the role of angel investor groups in providing capital to small businesses should be encouraged. These groups typically are knowledgeable and sophisticated and are able to fend for themselves, obviating the need for as many investor protections as are needed by the general public. Moreover, angel investor groups often have direct access to a company's management, facilitating the ability of these groups to fend for themselves. Finally, if the angel investor group was to assume the responsibility for verifying a member's accredited status, a compliance burden would be removed from the small business issuer likely enhancing capital formation.

But what started out as a good bill became convoluted by including governmental entities, colleges and universities, and nonprofit groups among those hosting sales events. Unlike angel investor groups, the typical employees of these entities are not accredited investors and largely lack the knowledge and sophistication to fend for themselves – it is citizens exactly like these individuals that the securities laws are meant to serve. General solicitation and general advertising of sales events to be hosted by governments, universities, and not-for-profits will almost certainly attract unsophisticated and non-accredited investors. Waiving the 506(c) requirement for the issuer to take reasonable steps to verify accredited status for sales events held at these venues will almost certainly expose individuals to financial risks they are not well positioned to take, without the knowledge or skill set to evaluate these risks, and without the broader protections afforded by the normal SEC review and disclosure process. In a nutshell – self-certification is no certification.

Fostering Innovation Act of 2015 (not yet numbered)

This bill (not yet numbered; hereafter referred to as FIA) would extend the waiver of auditor reporting on the effectiveness of an issuer's controls over financial reporting (ICFR) (SOX section 404b) for certain Emerging Growth Companies (EGC) from five years to as long as 10 years. Over the last five years, smaller businesses have already received substantial relief from the requirements of Section 404(b). First, the Dodd-Frank Act exempts public companies with a

market capitalization of less than $75 million from Section 404(b) of the Sarbanes-Oxley Act (SOX). Dodd-Frank's permanent exemption from 404(b) removed approximately 60 percent of public companies from the requirements of 404(b). Second, the JOBS Act waives Section 404(b) for EGCs for five years, or earlier if the EGC obtains a public float of more than $700 million, has gross revenues in excess of $1 billion, or has issued debt in excess of $1 billion. FIA would extend the 404(b) waiver for formerly EGCs as long as their public float is $700 million or less and they have annual average gross revenues of less than $50 million. This extension could last for up to 10 years in total (an additional five years).

Further expanding the number of companies exempt from 404(b) is ill-advised because auditor reporting on ICFR is valued by investors, and because of the substantial benefits provided by auditor reporting to both investors and to companies themselves. In a recent survey by the PCAOB's Investor Advisory Group, 72 percent of surveyed institutional investors indicated that they relied on the ICFR opinion either "extensively" or "a good bit" (IAG 2015).[1]

Over the last five years, a large body of empirical research has emerged that establishes the importance of effective internal controls and the benefits of auditor reporting on internal control (see Schneider, Gramling, Hermanson, and Ye (2009) for a review of this literature). The most persuasive evidence on the value of auditor reporting on internal control comes from a study by Bedard and Graham (2011). Bedard and Graham examine issuers with revenues of $1 billion or less. They find:

- Auditors, rather than management, detect approximately 75% of the unremediated internal control deficiencies. As Bedard and Graham point out, "Importantly, this low level of client detection occurs when clients are aware that auditors will soon follow with their own tests."
- When managers detect the internal control deficiency, they tend to classify the deficiency as less severe, but auditors frequently override those classifications.
- A significant percentage of the internal control deficiencies in the control environment component and related to the revenue account are detected by auditor control testing. This is germane because fraud is often associated with control environment weaknesses and revenue is the account most typically misstated when fraud occurs (Beasley, Carcello, and Hermanson 1999; Beasley, Carcello, Hermanson, and Neal 2010).

Any decision to exempt smaller public companies from auditor internal control testing under Section 404(b) ignores the ample evidence that internal control problems are often most serious in smaller public companies. Doyle, Ge, and McVay (2007) find that issuers with more serious (entity-wide) control problems are generally smaller and younger. In addition, those companies

[1] The surveyed institutional investors had cumulative assets under management of $13.4 trillion.

charged with financial statement fraud by the SEC tend to be relatively small (Beasley, Carcello, and Hermanson 1999; Beasley, Carcello, Hermanson, and Neal 2010). Moreover, Donelson et al. (2015) find a positive relation between a material weakness in internal control and the future revelation of fraud. As Bedard and Graham (2011) conclude, "... the recent exemption of Section 404(b) for smaller U.S. public companies could result in failure to fully realize potential improvements in financial reporting quality in that sector of the market."

Not only do investors benefit from auditor reporting on ICFR, issuers (companies) do as well. Feng et al. (2015) find that companies with inventory-related material weaknesses take longer to sell their inventory and are more likely to have to write off inventory amounts. Companies that fix these inventory-related weaknesses experience increases in sales, gross profits, and operating cash flows. Feng et al. (2009) find that companies with a material weakness in internal control issue less accurate earnings guidance, and given the difficulty that small companies have with analyst coverage, less accurate earnings guidance makes it less likely that analysts will cover the company. Finally, Costello and Wittenberg-Moerman (2011) find that companies with an material weakness in internal control have to pay higher interest rates to lenders and to post additional collateral. Given the precarious nature of small business financing, maintaining and demonstrating effective ICFR, through a "clean" opinion under 404(b), should have the effect of facilitating more advantageous lending to small businesses.

Given the weight of the empirical evidence on the efficacy of auditor involvement in testing and reporting on internal control, exempting more issuers from such auditor involvement seems adverse not only to the interests of investors, but equally to the interests of small businesses who this change is designed to benefit.

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Testimony of the Honorable Joseph A. Grundfest*

before the

Subcommittee on
Capital Markets and Government Sponsored Enterprises

Committee on Financial Services
United States House of Representatives

Fair or Foul? SEC Administrative Proceedings and
Prospects for Reform Through Removal Legislation

December 2, 2015

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Fair or Foul? SEC Administrative Proceedings and Prospects for Reform Through Removal Legislation

Joseph A. Grundfest*
Stanford Law School and
The Rock Center for Corporate Governance

December 2, 2015

Chairman Garrett, Ranking Member Maloney, and distinguished members of the Committee, thank you for this opportunity to testify on an important matter relating to the enforcement of our nation's securities laws.

H.R. 3798, the Due Process Restoration Act of 2015, addresses a significant perceived inequity in the United States Securities and Exchange Commission's ("SEC" or "Commission") administration of justice. I welcome this opportunity to address the concerns that animate this valuable legislative initiative. This testimony describes criticisms of the fairness of SEC administrative proceedings, discusses how a removal statute might address those concerns, considers the approach of the Due Process Restoration Act, and offers an alternative removal strategy that Congress might also consider.

I. Consternation over the SEC's Administrative Procedures

The SEC can choose between two forums in which to initiate enforcement proceedings. It can sue in federal court, where defendants have the right to a jury trial, can take deposition testimony, testimony is subject to the Federal Rules of Evidence, and judges are entirely independent of the agency and have been nominated by the President and confirmed by the United States Senate. Or, it can file an administrative proceeding that is conducted in-house before administrative law judges ("ALJ"s), where there is no jury, where discovery is restricted, where hearings proceed on a rapid schedule that can advantage the Commission's staff, where the Federal Rules of Evidence do not apply, where prosecutors and judges are all in the employ of the Commission, and where the initial appeal is to the same body that issued the order instituting the proceedings.

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Critics also complain that the ALJs, who purportedly wield administrative expertise, generally have little or no experience with the federal securities laws prior to their appointment. Critics also assert that ALJs are biased in favor of their employer, and at least one former ALJ has made statements consistent with the existence of such bias. Further, critics point to data suggesting that the Commission has a higher success rate in its in-house litigation than in litigation before federal courts. These data are, however, contestable and significant further research is appropriate before these comparisons can be made with confidence.

In addition, critics complain that appeals from ALJ decisions are to the same body that authorized the complaint. The five Commissioners thus act both as prosecutor and judge: prosecutors when authorizing the complaint and judges when ruling on the appeal from the ALJ decision resolving the complaint they initially authorized. While respondents have the right to appeal any Commission ruling to a federal court of appeals, the Kafka-esque quality of an appeal to the body that authorized the prosecution cannot be denied.

The Commission's appellate review also often concludes long after the initial ALJ decision. Indeed, these delays can be so lengthy that whatever speed is gained by the administrative "rocket docket" is lost while waiting for Commission review. Respondents thus experience a "hurry up and wait" regime that delays review by Article III judges nominated by a President and confirmed by the Senate.

Separate and apart from these complaints about the fairness of the agency's proceedings, the agency's push to administrative proceedings raises a concern that it is on a mission systematically to substitute its interpretation of the federal securities laws for that of the federal judiciary. The Commission's statements in a recent administrative proceeding provide a basis for these concerns.[1] Because the Commission's interpretation of the federal securities laws can often conflict with decisions reached by federal courts, the substitution of the Commission's interpretations for the courts' can have material consequences for the evolution of the law. At least one federal judge has warned of this development,[2] and the Commission appears to expect that its interpretation of the federal securities laws will, under the doctrine of *Chevron* deference, take precedence over conflicting interpretations by the federal courts. Whether the courts will accede to the Commission's view remains to be seen.

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[1] *See In the Matter of John P. Flannery and James D. Hopkins,* Securities Act Release No. 33-9689 (Dec. 15, 2014) (citing the "agency's experience and expertise in administering securities law," the Commission opinion set out its own legal interpretation to resolve what it termed "confusion" and "inconsistencies" among the federal district courts concerning the scope of primary liability for fraud under the federal securities laws).

[2] The Honorable Jed S. Rakoff, United States District Court for the Southern District of New York, Keynote Address to the Practicing Law Institute, Securities Regulation Institute, *Is the SEC Becoming a Law Unto Itself?* (Nov. 5, 2014).

Litigation is also afoot challenging the constitutionality of the process by which ALJs are appointed and can be removed. The resolution of these constitutional disputes, significant as they are, will not affect the debate about the fairness of the agency's administrative procedures. The concerns that animate the Due Process Restoration Act of 2015 are likely to survive the resolution of any associated Constitutional controversies.

II. The Commission's Response

The Commission is well aware of these criticisms but has nonetheless announced its intent to increase its reliance on its administrative proceedings while bringing fewer cases in federal court. In its defense, the Commission asserts that its administrative proceedings are fair and efficient. It explains that in administrative proceedings it is required to produce its entire investigative file, and that respondents have the protection of the Jenks Act and of the Supreme Court's decision in *Brady v. Maryland*.[3] It also emphasizes its investor protection mission. But even so, critics are not appeased. They emphasize that these protections are far from sufficient given the realities of modern litigation against the agency. Moreover, while the agency certainly has an investor protection mission, basic principles of procedural fairness need not and should not be sacrificed so that the agency can pursue its goal. Balance is necessary and appropriate.

The Commission has not, however, been entirely deaf to critiques of its administrative processes, and has recently responded with three distinct strategies.

First, the Commission has issued a statement describing four factors it considers when deciding whether to initiate proceedings in an administrative forum or in federal court. These factors have been criticized as exceptionally malleable and as not placing any meaningful limit on the Commission's exercise of discretion.

Second, the Commission has improved the format by which it reports its annual enforcement statistics. This improvement is a significant step forward over the prior regime, but room for improvement remains, particularly with regard to the methods used to describe the Commission's exercise of its forum selection option.

Third, the Commission has proposed to amend some rules governing its administrative proceedings. In particular, it has proposed to allow the staff and respondents to take up to three depositions each in cases in which there is only one respondent, and up to five when there is more than one respondent.

The criticism of this proposal was swift and sharp. To be sure, three or five depositions are better than none, but where do the magic numbers of three and five come from? What is the basis for these limitations, or are they arbitrary and capricious because the limitations are not related to the need for depositions in any

[3] 373 US 83 (1963).

particular case, and thus in violation of the Administrative Procedure Act? And, not only are three and five a small number of depositions in complex matters, "but figuring out which witnesses to depose may involve a large degree of guesswork if the agency took testimony from a number of people in its investigation, as is often the case."[4] Perhaps the better approach would be to allow a potentially unlimited number of depositions at the discretion of the ALJ, where the number is commensurate with the complexity of the matters at issue.

The Commission has also proposed to lengthen the time period during which respondents can prepare for a hearing and take the depositions that the Commission proposes to permit. But critics observe that "the time within which an administrative case would be completed is still fairly short,"[5] particularly when the matter is complex and involves hundreds of thousands of documents. The effect of the rocket docket can also be asymmetric because the Commission's staff will often have had years with which to prepare its case and take witness testimony. In contrast, respondents have to prepare furiously within a relatively short time frame. Again, perhaps the better approach would be to allow for greater exercise of discretion by ALJs in matters that raise a sufficient degree of complexity.

The Commission also proposes to formalize the admissibility of hearsay evidence provided that it "bears satisfactory indicia of reliability so that its use is fair."[6] Commenters were quick to observe that this standard is more permissive than the rule in federal court, but it should also be observed that these amendments are no worse than the *status quo*. Under the proposed rule, "some out of court statements, like the investigative testimony of witnesses could be considered without having to call them to attend the hearing, which avoids the risk they might say something different or lose credibility on cross examination."[7] And, with a limit of three or five depositions, and with the prospect of dozens of investigative witnesses having their testimony admitted without any right to depose or cross examine, the agency's willingness to allow such a limited number of depositions seems a drop in the bucket, particularly in large, complex matters. This issue could be addressed by applying specific provisions of the Federal Rules of Evidence in administrative proceedings, and, again, by permitting discretionary increases in the number of depositions and in the length of proceedings in complex matters.

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[4] Peter J. Henning, *A Small Step in Changing SEC Administrative Proceedings*, N.Y. TIMES (Sept. 28, 2015), http://www.nytimes.com/2015/09/29/business/dealbook/a-small-step-in-changing-sec-administrative-proceedings.html.

[5] *Id.*

[6] Proposed Amendments to the Commission's Rules of Practice 18, Exchange Act Release No. 34-75976 (Sept. 24, 2015) (hereinafter, "Proposed 2015 Procedural Amendments").

[7] Henning, *Small Step, supra* note 2.

In the aggregate, as a leading legal columnist writing for the New York Times has observed, these measures are "at best small steps in responding to criticism about truncated rights."[8]

III. Removal Statutes: Strategic Considerations

If Congress wants to address the matter head on, it could rewrite the Commission's internal rules of procedure or could specify minimum standards that more closely align the procedural fairness of APs with district court litigation. An alternative approach would have Congress consider the possibility of a removal statute as a mechanism that can induce the agency to make its proceedings more fair and equitable. Put another way, a removal statute can perform a valuable equilibrating function even if few cases are ever actually removed to federal court.

When considering a removal statute, Congress will have to weigh several competing considerations. First, removal increases the docket load before an already burdened federal judiciary. Congress should not lightly embark on any initiative that exacerbates that problem. Therefore, fashioning a removal mechanism that induces the agency to reform its own internal procedures may be more important than legislation that generates a large number of removals.

Second, the Commission's administrative process need not mimic every jot and tittle of the Federal Rules of Civil Procedure or of the Federal Rules of Evidence. There is also no constitutional requirement that a respondent in an administrative process have the right to a jury trial. The challenge in drafting a removal statute is to induce the agency to strike the proper balance in its internal processes while assuring access to federal courts whenever the interests of justice are best served by the application of the full panoply of rights available only in federal courts.

Third, Congress should recognize that the vast majority of SEC proceedings, whether filed administratively or in federal court, are settled, as is the case with the vast majority of all other civil and criminal actions. The dominant effect of a removal statute may therefore be to influence the terms of these settlements or the rules by which an administrative proceeding will occur. The prospect of litigating in an administrative forum in which the respondent has greater rights might induce the agency to drop some weaker cases and to focus on situations where evidence of harm is stronger. Greater procedural rights might also persuade the Commission to settle matters on terms more favorable to respondents. This observation underscores the fact that rational respondents will today agree to settlement terms that reflect the agency's strong procedural advantage in administrative proceedings, and not just the actual merits of the litigation at issue. In other words, the Commission might sometimes be able to extract more onerous settlement terms not

[8] Peter J. Henning, *Reforming the SEC's Administrative Process*, N.Y. TIMES (Oct. 26, 2015), http://www.nytimes.com/2015/10/27/business/dealbook/reforming-the-secs-administrative-process.html.

because its case is strong, but because respondent rights are weak. And, in cases that are not simultaneously filed and settled, a removal statute might incentivize the agency to agree to a larger number of depositions or longer periods for preparation in order to persuade a court that removal is neither necessary nor appropriate.

It follows that a removal mechanism that allows for the federal judiciary to perform a valuable monitoring and filtering function could serve a constructive role. Federal judges may be best situated to determine whether a case should responsibly remain with the agency to be adjudicated under truncated procedures, or whether the interests of justice call for the greater procedural guarantees provided in federal court. Federal judges are also best positioned to balance the burden that additional proceeding place on their dockets.

IV. Removal Statutes: Tactical Considerations

Congress can employ many different mechanisms when drafting a removal statute. The simplest approach designates a category of proceedings as to which respondents have an unconditional right of removal. Congress can expand or contract the set of removable actions to balance the potential additional burdens imposed on the federal courts.

H.R. 3798 falls in this category. The pending bill would allow any respondent in any administrative proceeding in which the Commission seeks "an order imposing a cease and desist order and a penalty ... [to] require the Commission to terminate the proceeding." The Commission would then be authorized to bring a civil action "against that person for the same remedy that might be imposed." The bill would also change the standard of proof in SEC administrative proceedings to require "clear and convincing evidence that the person has violated the relevant provisions of law."

The pending bill has many virtues. Simplicity is one. There is no ambiguity as to which causes of action can be removed, how they can be removed, and the consequences of removal. Predictability is another. The most important SEC enforcement actions typically call for cease and desist orders and monetary penalties. A very large percentage of these cases will likely shift to federal court if the legislation is enacted as proposed. Further, the standard of proof in civil actions requires a "preponderance of the evidence." H.R. 3798 would alter the standard in administrative proceedings to a more exacting "clear and convincing evidence" test. The proposed legislation would thereby create an evidentiary incentive for the SEC to prefer federal court to administrative proceedings. Because the higher evidentiary standard would also apply to proceedings that cannot be removed to federal court, the Commission would find it more difficult to prevail in all of its administrative proceedings.

But as is the case with all legislative initiatives, there are costs that also warrant consideration. H.R. 3798 would increase the federal judiciary's caseload

with a set of potentially complex matters without considering the optimal forum for each matter. It would also make it systematically more difficult for the agency to prevail in all of its administrative proceedings. It would also not provide the agency with effective incentives to engage in appropriate self-reform designed to improve procedural safeguards without increasing the burden on the federal docket. As observers have suggested, H.R. 3798 could effectively eliminate administrative proceedings as a mechanism for resolving all significant securities fraud matters.

An alternative design of a removal statute might recognize that there are three categories of cases that can be brought as administrative proceedings.

The first set of cases involve technical or other *pro forma* matters that, whether or not they involve cease and desist orders or penalties, are best determined by the Commission and need not, under any circumstances, clutter the federal courts' dockets.[9]

A second category would be composed of cases as to which respondents would have an unqualified right of removal, much as suggested by HR 3798. These cases would involve fact patterns or applications of law, where, in the determination of Congress, the procedural guarantees associated with federal court proceedings, as well as the availability of a jury and the presence of an Article III judge, warrant the additional imposition on the federal docket.[10]

As for all other cases, the statute could provide for a right to petition a federal court for an order removing the case from the Commission and assigning it to federal court. Removal would be at the discretion of the District Court judge to whom the petition is assigned. The entire process could also be modeled on existing Federal Rule of Civil Procedure 23(f) that creates a discretionary interlocutory appeal from a district court ruling on a motion for class certification. Indeed, the very rationale for the adoption of Rule 12(f) mirrors the rationale for the adoption of a removal statute.[11] Further, to facilitate the district courts' consideration of petitions for removal, the statute could define specific "core factors" for the district courts to consider when evaluating these motions, much as the courts have evolved

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[9] Examples of these cases might be late filing cases or complaints alleging violations of the Commission's complex net capital rules. As to these cases, the removal statute would not allow any right of removal at all.

[10] Examples of these cases might include alleged violations of the anti-fraud provisions, insider trading laws, or the anti-bribery provisions of the Foreign Corrupt Practices Act.

[11] The drafters of Rule 23(f) recognized that the decision on a class certification motion could, as a practical matter, be outcome determinative without any regard to the merits of the underlying action. Therefore, granting the Courts of Appeal the discretionary right to engage in interlocutory review promoted the interests of justice. By the same token, the decision as to whether a case should proceed as an administrative matter or as a dispute in federal court can also be outcome determinative. Therefore, granting the federal district courts the discretionary right to order removal to federal court can also promote the interests of justice.

"core factors" that govern the decision as to whether to grant a Rule 23(f) motion.[12] To be sure, the creation of a discretionary right to petition for removal raises a host of operational complexities that would have to be addressed, but all of these issues should be manageable.

As outlined, the goal of this discretionary removal provision is not to cause a massive migration of litigation from the SEC's administrative process to the federal courts. It is, instead, to give the agency powerful incentives to reform its internal procedures so that the courts do not feel compelled to grant a large number of these petitions. Indeed, to the extent that a removal statute can stimulate the Commission to reform its internal processes so that they are perceived as fair and efficient by the courts and by Congress, and not just by the Commission, removal legislation can promote the interests of justice without over-burdening federal court dockets.

V. Conclusion

The Commission faces a crisis of confidence over the fairness of its internal administrative procedures. The Commission can respond by changing its internal policies, and preliminary data suggest that some changes may already be afoot. Properly designed legislation that grants respondents the right to petition for removal to federal court can also act as a powerful incentive for the Commission to reform its internal procedures. The goal would be to have a set of procedures that are perceived as fair and efficient by Congress and by the courts, and not just by the Commission itself. Properly designed legislation would also be sensitive to the burdens that a removal can impose on federal caseloads. Most importantly, perhaps, properly designed legislation can promote the interests of justice by assuring that litigation matters are responsibly sorted so that cases that warrant the full protection of a jury trial and of the Federal Rules of Civil Procedure and of the Federal Rules of Evidence are heard in federal court, whereas cases that are more appropriately resolved in the administrative forum remain before the agency.

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[12] These factors might include:

1. The presence of complex regulatory matters that are better resolved by an administrative law judge than by a jury or Article III judge;
2. The value of fact-finding by a jury and not by an administrative law judge;
3. Whether the respondent is a regulated entity;
4. Whether the litigation involves a level of complexity that cannot be fairly resolved given the procedural rules employed by the Commission as of the date of the order instituting proceedings;
5. The implications of the remedy sought by the Commission for the respondents' businesses and careers; and
6. The presence of significant questions of law that would benefit from resolution by the federal judiciary, rather than by the Commission seeking *Chevron* deference to its interpretation of the federal securities laws.



Brian Hahn

Chief Financial Officer, GlycoMimetics, Inc.

On behalf of the Biotechnology Industry Organization

Before the United States House of Representatives Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises

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Legislative Proposals to Improve the U.S. Capital Markets

December 2, 2015

Executive Summary

- GlycoMimetics is a clinical-stage biotechnology company based in Rockville, Maryland. The Biotechnology Industry Organization (BIO) represents GlycoMimetics and more than 1,100 other innovative biotech companies, the vast majority of which are pre-revenue small businesses.

- GlycoMimetics undertook a successful IPO in January 2014 using key provisions in the Jumpstart Our Business Startups (JOBS) Act. More than 180 biotech companies have gone public as emerging growth companies (EGCs) under the JOBS Act, a dramatic change from the constricted IPO environment prior to the law's enactment.

- A healthy public market is key to funding the search for innovative, next-generation medicines and maintaining the U.S. as a global leader in 21st century industries like biotechnology. BIO supports policies that *increase* the flow of capital to innovative small businesses and *decrease* capital diversions from the lab to unnecessary compliance burdens.

- It can take more than a decade and cost more than $2 billion to bring a single biotech therapy to patients in need. Biotech research is funded almost entirely by investment capital because emerging biotechs operate without any product revenue.

- BIO supports the Fostering Innovation Act, which would extend the JOBS Act's Sarbanes-Oxley (SOX) Section 404(b) exemption for an additional five years for former EGCs that maintain a public float below $700 million and average annual revenues below $50 million.

- BIO supports the SEC Small Business Advocate Act (H.R. 3784), which would create an Office of the Small Business Advocate at the SEC and grant emerging companies an important voice in the SEC's rulemaking process.

- BIO supports the Small Business Capital Formation Enhancement Act, which would require the SEC to take action on recommendations made by the SEC Government-Business Forum on Small Business Capital Formation.

- BIO supports the HALOS Act, which would support small businesses and their investors during the Regulation D, Rule 506(b) offering process.

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Testimony of Brian Hahn

Good morning Chairman Garrett, Ranking Member Maloney, and Members of the Subcommittee. My name is Brian Hahn, and I am the Chief Financial Officer at GlycoMimetics, Inc., a clinical-stage biotechnology company located in Rockville, Maryland. GlycoMimetics is a small business with 40 employees, all of whom are dedicated to our search for next generation medicines.

Our lead product candidate is a treatment for patients undergoing acute crises caused by sickle cell disease. These critical events are extremely painful and hard to treat beyond simple palliative care, but we hope to address sickle cell crises more effectively by ending the crisis more quickly, avoiding opioid painkiller use, and reducing a patient's hospital stay. We are also conducting Phase 1/2 clinical trials for a treatment that has the potential to increase the ability of chemotherapy to kill cancer cells in patients suffering from acute myeloid leukemia (AML). We expect to expand that candidate's testing in 2016 to treat patients with multiple myeloma as well. These medical advances – all of which have been developed in-house by the dedicated scientists at GlycoMimetics – would dramatically improve the quality of life for patients and their families.

The research we are undertaking at GlycoMimetics is mirrored across the biotech industry. Biotech companies are engaged daily in the search for the next generation of cures and treatments, and our colleagues across the country share GlycoMimetics's passion for developing life-changing medicines for patients in need. The Biotechnology Industry Organization (BIO) represents over 1,100 innovative biotech companies, including GlycoMimetics, in all 50 states. The vast majority of these companies are emerging, pre-revenue businesses working in the lab to move life-saving science forward. I serve as the Co-Chair of BIO's Finance and Tax Committee, a group of finance professionals dedicated to ensuring a policy environment that supports the capital formation necessary to fund our industry's vital research.

Policies that encourage capital formation are of paramount importance to growing biotechs, because investment capital is the lifeblood of scientific advancement. It costs over $2 billion to develop a single life-saving treatment, and most companies spend more than a decade in the lab before their first therapy is approved. During this long development process, virtually every dollar spent by an emerging biotech comes directly from investors. Expenses ranging from buy-in-bulk beakers to $150 million clinical trials are all funded by investment capital because biotechs remain pre-revenue through their entire time in the lab and the clinic.

Early-stage innovators do not have the luxury of funding their product development through sales revenue. Instead, the groundbreaking research that leads to a company's first product is funded by a series of financing rounds from angel investors, venture capitalists, large pharmaceutical companies, and, eventually, public market investors. The capital burden of a pivotal clinical trial – which can require hundreds of patients in the clinic to meet the stringent safety and efficacy standards necessary to ensure patient care – often necessitates an IPO to fund this critical stage of the research process.

GlycoMimetics undertook an IPO in January 2014, raising $64 million to fund the next phase of our research. Our IPO was supported by the Jumpstart Our Business Startups (JOBS) Act, a game-changing reform of the public offering process that offers a scaled compliance regime for companies through the fifth anniversary of their IPO. Prior to the passage of the JOBS Act, the recession had severely curtailed biotech financing – more than 100 public biotechs closed their doors, venture financing dried up, and small companies had few



options to fund their research. Since 2012, we have seen a sea change on the market. Numerous biotechs have capitalized on the success of the JOBS Act, using its provisions to enhance their IPO and secure capital for advanced research and costly clinical trials. To date, the JOBS Act has supported over 180 biotech IPOs – a dramatic surge that highlights the impact of effective policymaking on the capital formation ecosystem.

Because pre-revenue small businesses utilize only investment dollars to fund their work, they place a high value on policies like the JOBS Act that incentivize investment in innovation and prioritize resource efficiency. Any policy that increases the flow of innovation capital to emerging companies could lead to funding for a new life-saving medicine – while any policy that diverts capital to unnecessary and costly regulatory burdens could lead to the same treatment being left on the laboratory shelf.

The JOBS Act represents a significant move away from costly one-size-fits-all regulations. This important law allows emerging growth companies (EGCs) to have enhanced access to investors via testing-the-waters meetings, increasing the likelihood that an offering will be successful. It then takes the vital step of reducing the regulatory burden on EGCs, ensuring that the capital raised in an offering is not subsequently diverted from R&D and company growth. This one-two punch is critical for biotech innovators and has increased the viability of the public market for growth-stage businesses looking to fund their capital-intensive development programs. I applaud the Subcommittee for considering legislation that would build on the success of the JOBS Act and support a regulatory environment that prioritizes capital formation and resource efficiency at growing companies.

Disclosure Effectiveness and the Fostering Innovation Act

Sarbanes-Oxley Section 404(b)

One key reason that the JOBS Act has been so effective for emerging biotechs like GlycoMimetics is its emphasis on appropriately tailored regulatory burdens. One-size-fits-all compliance requirements have a uniquely damaging impact on biotech companies. These regulatory burdens do not meet their intended purposes because they require the reporting of information that is irrelevant to our business model. For pre-revenue small businesses, the significant time and fiscal burdens divert critical capital from science to compliance. This problem is exacerbated by the fact the SEC has a very narrow definition of what constitutes a small company, meaning that any scaling of regulatory burdens reaches only the lowest-valued of issuers.

Emerging biotechs are the very definition of a small business. At GlycoMimetics, we have just 40 employees, and 31 of them are directly involved in the research and development supporting our product candidates. Our income statement shows capital flowing directly from investors to the lab. And yet the SEC does not consider us "small" because our public float – a measure of investors' predictions about our growth potential and future value, not our current size – exceeds the SEC's arbitrary $75 million cap. This $75 million ceiling defines the SEC's smaller reporting company (SRC) and non-accelerated filer universe. These growing businesses rightly receive certain regulatory allowances and exemptions, but the current definition is extremely limited, and thus fails to capture a broad swath of small public companies that would benefit from a move away from one-size-fits-all regulations.

The most damaging aspect of the SEC's approach to company classification is the diversion of capital from science to compliance dictated by Sarbanes-Oxley (SOX) Section 404(b). Section 404(b) requires an external auditor's attestation of a company's internal financial controls that provides little-to-no insight into the health of an emerging biotech company –



but is extremely costly for a pre-revenue innovator to comply with. Non-accelerated filers are exempt from Section 404(b), which means that all companies with a public float above $75 million must comply. An SEC study published in 2011 found that SOX Section 404(b) compliance can cost over $1 million annually, a staggering sum for a pre-revenue small business.

Biotech investors demand information about the growth-stage companies in which they invest – and spend countless hours learning as much as they can about the company's science, the diseases it is treating, the patient population, the FDA approval pathway, and a hundred other variables that will determine the company's ultimate success or failure. The testing-the-waters process created by the JOBS Act has been so successful for the biotech industry because it allows companies a platform to disseminate *more* and *more detailed* information to potential investors. But the information that these investors want and need does not align with what is required by SOX – and yet virtually all companies are subject to this one-size-fits-all mandate that can cost them over $1 million per year.

Congress took the important step of exempting EGCs from Section 404(b) compliance in the JOBS Act, and GlycoMimetics has benefitted from being able to spend dollars on R&D and job creation that otherwise would have been earmarked for SOX compliance. The IPO On-Ramp is a welcome five-year window wherein the securities laws see GlycoMimetics as the small company that we truly are. However, it remains the case that the biotech development timeline is a decades-long affair. It is extremely likely that GlycoMimetics will still be in the lab and the clinic when our EGC clock expires – which is to say that we will still not be generating product revenue. Our audit fees increased by roughly $400,000 after our IPO due to the existing regulatory environment for public companies, and we expect our SOX 404(b) compliance obligations alone to further increase costs by more than $350,000 annually starting in year 6 post-IPO. Those valuable funds could cover clinical costs for a more than a dozen patients, but our innovation capital will instead be spent on unnecessary reporting burdens.

Most biotechs that went public under the JOBS Act will find themselves in the same predicament at the dawn of year 6 on the market – still reliant on investor capital to fund their research, but facing a full-blown compliance burden identical to that faced by commercial leaders and multinational corporations.

The Fostering Innovation Act

Reps. Kyrsten Sinema and Michael Fitzpatrick have introduced the Fostering Innovation Act, which would extend the JOBS Act's SOX 404(b) exemption for certain small companies beyond the existing five-year expiration date. This important bill recognizes that a company that maintains the characteristics of an EGC but has been on the market beyond the five-year EGC window is still very much an emerging company.

The Fostering Innovation Act would apply to former EGCs that have been public for longer than five years but maintain a public float below $700 million and average annual revenues below $50 million. These small businesses would benefit from an extended SOX 404(b) exemption for years 6 through 10 after their IPO. The additional five years of cost-savings would have the same impact as the first five years – growing companies would be able to spend investor capital on growing their business. In the biotech industry, that means small business innovators can remain laser-focused on the search for breakthrough medicines.

If a company eclipses $50 million in average annual revenues, its full SOX 404(b) compliance obligations would kick in. The Fostering Innovation Act does not grant a carte

blanche exemption – it is targeted specifically at pre-revenue companies, because revenue is the key indicator of company size, and of the ability to pay for expensive compliance obligations like Sarbanes-Oxley. Maintaining the JOBS Act's public float test of $700 million while drastically lowering the revenue test from $1 billion to $50 million limits the Fostering Innovation Act to a specific universe of truly small companies – instituting a company classification regime for years 6 through 10 post-IPO that accurately reflects the nature of small businesses while also supporting their growth.

Under current law, small, pre-revenue companies are often required to file the same reports as revenue-generating, profitable multinational corporations. Under the Fostering Innovation Act, these emerging companies will save millions of dollars that can be utilized to fund the groundbreaking R&D and life-saving medical research. BIO and I strongly support this vital legislation, and I want to thank Reps. Sinema and Fitzpatrick for taking this important step to support capital formation and company growth at America's pre-revenue businesses.

Fulfilling the SEC's Mission to Facilitate Capital Formation

BIO and I appreciate the steps the Subcommittee is taking to support the SEC's mission of facilitating capital formation while maintaining efficient markets and protecting investors. The SEC has the ability to be a key facilitator of capital formation, and its expertise can be brought to bear in designing policies that support company growth, reduce one-size-fits-all compliance costs, and enhance the capital formation potential of the public markets. The Subcommittee is considering legislation today that would encourage the SEC to support small business capital formation and ensure that the concerns of growing companies remain at the forefront of the SEC's decision-making process.

H.R. 3784, the SEC Small Business Advocate Act

The SEC Small Business Advocate Act (H.R. 3784), sponsored by Reps. John Carney, Sean Duffy, Ander Crenshaw, and Mike Quigley, would establish an Office of the Small Business Advocate at the SEC. The Small Business Advocate would serve as a partner to the existing Investor Advocate, giving small businesses an independent voice at the SEC and helping the SEC to understand the impact of regulatory burdens on growing companies as it considers new compliance requirements.

Involving small businesses in the regulatory process would ensure that the SEC considers the effect that its rules have on growing companies across the country. As I have mentioned, overly burdensome compliance requirements have an inordinate impact on small businesses, and the Small Business Advocate would be charged with helping the SEC move away from one-size-fits-all rules. The Small Business Advocate could also be a source of new policy ideas that would incentivize and support capital formation. Proactive regulations and programs designed to drive investment to growing innovators would fulfill the SEC's mission to facilitate capital formation.

The proposed Office would also organize and support the SEC Advisory Committee on Small & Emerging Companies and the SEC Government-Business Forum on Small Business Capital Formation. These two groups convene private sector stakeholders to formulate policy recommendations that would support small business growth. BIO has long supported the work of these groups, both of which endorsed the policy ideas that eventually became the JOBS Act. Bringing the Advisory Committee and the Government-Business Forum under the auspices of the new Office of the Small Business Advocate would create an exciting hub for



policy formulation to support the capital needs of growing businesses powering the American economy.

BIO and I believe that the proposed Office of the Small Business Advocate would improve the regulatory regime for growing companies by giving them a strong voice at the SEC. The regulations and policy decisions made by the SEC have a significant impact on emerging businesses, and regulators' choices impact the entire capital formation ecosystem. Ensuring that the SEC enacts policies that support the growth of innovative job creators will build on the success of the JOBS Act and further enhance the role that public capital plays in the search for groundbreaking discoveries and lifesaving medicines.

The Small Business Capital Formation Enhancement Act

The SEC Government-Business Forum on Small Business Capital Formation is an important venue for the business community to impact the policy development process in Washington. The Forum, which has convened annually since 1982, provides an opportunity for small businesses to recommend policy changes to the SEC that would reduce regulatory burdens and enhance capital formation.

Historically, the Forum has been adept at suggesting policies that have a real impact on growing companies. For instance, every title of the JOBS Act can trace its origins to the Forum. The Forum's 2011 report includes recommendations on the IPO On-Ramp, Regulation A+, Regulation D, crowdfunding, and Section 12(g) that would eventually pass Congress as the JOBS Act in March 2012. Put simply, small businesses understand their own regulatory environment, and are uniquely equipped to advise the SEC on how it could be reformed to enhance capital formation.

However, despite the fact that most Forum recommendations could be adopted by the SEC through its standard rule proposal process, the SEC is often reluctant to act. The JOBS Act's Regulation A+ and Regulation D proposals were, in one form or another, included in the Forum report for more than a decade before Congress stepped in and made a change. There are myriad examples of Congress recognizing the value of the Forum's recommendations even when the SEC does not. Just in this Congress, the Subcommittee has considered legislation inspired by the Forum that would exempt growing businesses from XBRL compliance (H.R. 1965, the Small Company Disclosure Simplification Act), increase the viability of Form S-3 for small companies (H.R. 2357, the Accelerating Access to Capital Act), and allow forward incorporation by reference on Form S-1 (H.R. 1723, the Small Company Simple Registration Act). Specific to today's hearing, the Forum has for years recommended expanding the small company exemption from SOX Section 404(b) compliance (as in the Fostering Innovation Act).

Congress clearly recognizes the Forum's value, and Rep. Bruce Poliquin has introduced the Small Business Capital Formation Enhancement Act to encourage the SEC to take steps to implement the Forum's recommendations on its own. Under the Small Business Capital Formation Enhancement Act, the SEC would be required to review the recommendations made by the Forum. For each recommendation, the SEC would have to provide an assessment of the policy proposed and subsequently disclose what action, if any, it intends to take with respect to the Forum's findings.

This legislation will encourage the SEC to act on the Forum's recommendations – with the goal of stimulating small business capital formation. This would better ensure that the SEC implements tailored policies that place appropriate emphasis on the capital needs of small businesses. If the SEC decides against taking up a policy change recommended by the

Forum, its assessment and input would enhance the dialogue around the Forum's recommendations, allowing participants to take the SEC's feedback into account in subsequent years, or offering Congress a chance to step in and craft legislation that combines the best of the Forum's and the SEC's policy preferences.

The Small Business Capital Formation Enhancement Act would enhance the role of the SEC Government-Business Forum on Small Business Capital Formation in the policymaking process, and, if it is enacted, BIO and I believe it would lead to smart regulations that support emerging company growth.

Rule 506 of Regulation D

BIO was a strong supporter of Title II of the JOBS Act, which removed the prohibition on general solicitation for offerings to accredited investors conducted under Rule 506 of SEC Regulation D. I support continued efforts to ensure that the Rule 506 offering process is structured appropriately so that it has the strongest possible impact on small business capital formation.

The HALOS Act

The JOBS Act directed the SEC to lift the ban on general solicitation for offerings conducted under Rule 506, provided that issuers take reasonable steps to verify that all purchasers in an offering are accredited. The SEC created Rule 506(c) to implement this reform while maintaining the "old" Regulation D as Rule 506(b), which does not allow general solicitation but also does not impose verification procedures on investors. These dual offering pathways provide valuable flexibility for investors, but there has been some confusion for small companies considering a traditional Rule 506(b) offering that do not want to inadvertently violate the new Rule 506(c) rules.

The Helping Angels Lead Our Startups (HALOS) Act, sponsored by Reps. Steve Chabot, Kyrsten Sinema, Robert Hurt, and Mark Takai, would clarify that presentations made at "demo days" or other government-, non-profit-, or angel-sponsored events would not violate the general solicitation prohibition in Rule 506(b). This change would remove roadblocks for investors and reduce confusion for companies deciding between Rule 506(b) and Rule 506(c) offerings.

Conclusion

The extraordinary success of the JOBS Act in the biotech industry means that the work of the Subcommittee has taken on increased import for emerging biotech companies. The search for capital in our industry is always ongoing – it does not end at the IPO. As such, BIO and I strongly support efforts by the Subcommittee to enhance the capital formation ecosystem, reduce regulatory burdens, and incentivize funding for the next generation of breakthrough medicines.

The most damaging facet of a one-size-fits-all regulatory regime for the biotech industry is the diversion of investment funds from science to compliance in the absence of product revenue. Biotech small businesses place a high value on capital efficiency, so I applaud the Subcommittee for considering legislation today that would reduce compliance costs for small businesses while also supporting capital formation.

Legislation like the Fostering Innovation Act will ensure that growing companies have the opportunity to be successful on the public market without being forced to siphon off

innovation capital to spend on costly compliance burdens that do not inform emerging biotech investors. The SEC Small Business Advocate Act and the Small Business Capital Formation Enhancement Act would put in place processes to implement similar policies that stimulate public capital formation. BIO and I believe that these important reforms will support the growth of emerging innovators beyond the IPO On-Ramp, incentivizing scientific advancement and sustaining small innovative businesses as they continue their efforts to bring life-saving treatments to patients who desperately need them.

I am thankful that Congress was able to pass the JOBS Act three and a half years ago, which supported GlycoMimetics's public offering, and I am hopeful that it will be able to enact further legislation – like the bills being considered today – that could support the search for breakthrough treatments at the next generation of emerging growth biotechs. I appreciate your dedication to these vital issues, and I look forward to supporting your work in any way I can.



Hearing on "Legislative Proposals to Improve the U.S. Capital Markets"
House Financial Services Committee
Subcommittee on Capital Markets & Government Sponsored Enterprises
December 2, 2015

Testimony by Chris Mathieu, Chief Financial Officer, Horizon Technology Finance Corporation (NASDAQ:HRZN)
On behalf of the Small Business Investor Alliance
www.SBIA.org



Good afternoon Chairman Garrett, Ranking Member Maloney, and Members of the House Financial Services Subcommittee on Capital Markets & Government Sponsored Enterprises.

I am here today representing the Small Business Investor Alliance or the "SBIA", which is the trade association of lower middle market private equity funds, SBICs, and business development companies or "BDCs" and their institutional investors. SBIA members provide vital capital to small and medium-sized businesses across the country.

My name is Chris Mathieu, Chief Financial Officer and co-founder of Horizon Technology Finance Corporation, an externally managed publically traded Business Development Company, or "BDC". I am also an original member of the team that founded Horizon's advisor. Horizon is based in central Connecticut with offices in Northern Virginia and Northern California.

I have been involved in the accounting, finance and venture debt industries for more than 25 years. After earning my Bachelor's degree in Accounting, I became a Certified Public Accountant and worked with the financial services group of KPMG. My background includes leadership positions here at Horizon, and business development roles in lending to the life science industry at great US based firms such as Transamerica and GATX.

Having serviced as a steward of investors capital for the last 25 years in both the public and private markets and for both institutional and individual investors, I believe I have a wide and deep perspective on the importance of having an advocate among the decision makers within an organization and industry and its underlying sectors.

Horizon is a specialty finance company that lends to and invests in development and growth stage companies in the technology and life science industries. Our investments take the form of secured loans, or "Venture Loans" to companies backed by established venture capital and private equity firms.

Horizon is a leading venture lending platform that has partnered with hundreds of venture capital investors to thoughtfully and creatively provide structured debt products to life science and technology companies. Horizon's experienced team of investment and operations professionals has been providing debt capital to some of the most exciting companies for decades. The members of the Horizon team have, collectively, originated and invested more than $3 billion in venture loans to thousands of companies. More recently, since 2004, Horizon has directly originated and invested more than $1.2 billion in growth capital loans to more than 170 growing companies.

With Horizon's industry knowledge and proven reliability as a capital source, combined with its long-standing relationships in the venture capital community, the Horizon team shares the optimism of its portfolio companies and their commitment to overcome any obstacles to success.

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Horizon's financing solutions are tailored to each company's unique funding needs and business and development plans. Horizon's venture debt products have become a valuable tool in the equity investors' toolbox to fund the growth of its portfolio companies, while maximizing returns on equity. Horizon provides portfolio companies with meaningful debt capital that can be used like equity capital, but that has a much lower cost and dilution to investors and employees. This balance of debt and equity capital makes Horizon a perfect partner for its portfolio companies, their employees and their investors.

Like its portfolio companies, Horizon is optimistic and forward-looking. Horizon balances its inherent optimism with a selective origination and a rigorous underwriting process. Horizon's selective origination ensures that Horizon and its prospects are not spending valuable time and energy when venture debt is not the right solution. This upfront communication serves as a gateway to a smooth underwriting and approval process. For each investment opportunity, Horizon carefully evaluates the company's management team, investors, equity history, technology value, intellectual property and other critical factors. Horizon's goal is not to simply get a deal done, but to provide a successful financing solution that will propel a portfolio company forward.

I am here to support a bipartisan bill called the SEC Small Business Advocate Act of 2015 (H.R. 3784), introduced by Representatives John Carney, Sean Duffy, Mike Quigley and Ander Crenshaw, and co-sponsored by Representative Brad Sherman. I would also like to support the Small Business Capital Formation Enhancement Act introduced by Representative Bruce Poliquin and the Helping Angels Lead Our Startups Act ("HALOS Act"), a discussion draft written by House Small Business Committee Chairman Steve Chabot and Representatives Sinema, Hurt, and Takai. I would like to thank the Subcommittee for examining these bills today.

I. The SEC Small Business Advocate Act of 2015

In a speech given by former Securities and Exchange Commission (SEC) Commissioner Daniel Gallagher, on September 17, 2014, the genesis of the SEC Small Business Advocate Act was born.[1] In his opinion, Mr. Gallagher argued that the SEC does not have an adequate structure in place to consider the views of small businesses. He argued that the SEC consistently overlooks the impact of their decisions on small businesses and this could be a detriment to capital formation.

We agree with Mr. Gallagher's assessment and believe Congress needs to put a permanent structure in place at the SEC to give a stronger voice to small businesses and capital formation issues. The SEC Small Business Advocate Act is the favored approach by the industry to create this new structure.

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[1] Commissioner Daniel M. Gallagher, *Whatever Happened To Promoting Small Business Capital Formation?,* Washington, D.C., September 17, 2014, *available at:* http://www.sec.gov/News/Speech/Detail/Speech/1370542976550.

As drafted in H.R. 3784, the Advocate will give small businesses and small business investors a voice in regard to proposed rules and regulations of the SEC and self-regulatory organizations (SROs) because small business investing is an afterthought in the policymaking process. Moreover, the new Advocate will have the knowledge and input of members of the newly established Small Business Capital Formation Advisory Committee (Advisory Committee) and finally provide a conduit for the ideas raised at the annual Government-Business Forum on Small Business Capital Formation. The new Advocate will have similar powers to the Dodd-Frank created Office of the Investor Advocate, giving small businesses an equal footing with investors in influence over SEC and SRO actions.

A. The Advocate Will Provide The Small Business Perspective on Proposed SEC and SRO Rulemakings To Lessen the Burden on Small Business and Small Business Investors

Many rules and regulations propagated and policed by the Commission impose disproportionate burden on small businesses, including accounting rules, securities offering rules, securities resale rules, disclosure rules and others. The myriad of rules and regulations prove costly and lengthy to navigate, often requiring small businesses to hire specialized lawyers and accountants to ensure they are in compliance. While many of these current rules and regulations may be necessary to protect investors, many could be streamlined and scaled for small businesses and small business investors, to ensure the benefits outweigh the costs to economic growth and job creation. The dual mandate at the SEC to protect investors and promote capital formation will be enhanced not hindered by the Advocate.

The Advocate will fulfill a much needed role in providing comments and input on proposed rules and regulations set forth by the SEC and SROs, including the relevant securities exchanges and FINRA. As former Commissioner Gallagher highlighted in his speech in September 2014, the SEC suffers from a dearth of small business comments on proposed rules and regulations, while the SBA's Office of Advocacy rarely has provided input on the impact of SEC rules on small businesses. The Advocate has the ability to bring on skilled staff, hire external experts, and actively reach out through regional roundtables to small businesses and small business investors to gather information on how proposed SEC and SRO rulemakings impact them, and apply the Advocate's expertise to expressing those concerns in an effective way with SEC staff. Having a team dedicated to this mission within the confines of the SEC, but not subject to pressure within the agency, will go a long way to ensure the independent voice of small business and small business investors is heard.

B. The Advocate will Promote Innovative Ideas For Small Business Capital Formation and Provide an Incubator and Outlet for New Ideas to Congress & the Commission

The SEC Small Business Advocate Act strengthens the voice of small business at the SEC by making significant changes to the way the SEC hears from small business stakeholders; responds to stakeholder requests; and makes recommendations to Congress and the SEC to improve the ability of small businesses to access capital.

This legislation arms the new Advocate for Small Business Capital Formation with the necessary tools to be the strongest voice possible in the SEC. For example, the legislation charges the advocate to produce an independent, annual report to Congress on its activities and recommendations. This report will provide a summary of the most serious issues encountered by small businesses and small business investors and recommendations for changes to regulations and other guidance that may be appropriate to resolve these problems. Smaller business investors have a much lower threshold for regulatory pain and the SEC needs to understand the challenges of scale when creating policy.

Congress would also benefit greatly from this office. Legislating good policy generally includes technical assistance and input from the regultors and SROs. The technical assistance given to Congress suffers from the same bias and focus on large corporations. Congress would benefit from having small business issues included in both the technical assistance it receives and in the way regulations are crafted when implementing legislation. Better information means better legislation.

The Act makes permanent the Small Business Capital Formation Advisory Committee (on which the Advocate has a permanent seat). The creation of a permanent and independent Advisory Committee will ensure that stakeholders have a seat at the table to respond to rulemakings and create ideas that the SEC can act on to help small businesses. Observing members include other regulatory stakeholders, including the U.S. Small Business Administration, and the state securities administrators. Making this Committee permanent ensures that the Advocate and the Commission generally will have a permanent group of small business investors and small business owners to provide constant feedback, and hold the SEC's feet to the fire. It also mirrors responsibilities of the Dodd-Frank created Investor Advisory Committee, giving the Small Business Advocate the same resources as the Investor Advocate.

The Act improves and makes stronger the Government-Business Forum because in its current form, the Forum is weak and unfortunately most of its ideas are often left for dead. While the Forum has generated a number of helpful improvements that were incorporated into the JOBS Act, the format of the Forum could be greatly improved, and given increased independence from the policy objectives of the Division of Corporation Finance. In addition, outreach and promotion of this event could be greatly strengthened to increase the number of stakeholders in attendance and provide enhanced educational opportunities from outside stakeholders. This event may then be transformed into what Congress intended when it mandated it in 1980.

Currently both the Advisory Committee on Small Business Capital Formation and the Government-Business Forum are under the stewardship of the Office of Small Business Policy, run by the Division of Corporation Finance. While the SEC has performed a noteworthy job in shepherding the JOBS Act rulemakings across the finish line, while also engaging in a solid stewardship of the Committee and the Forum, an independent office running these groups is critical. An independent office, in the form of the Advocate, will ensure that the issues raised by these groups are brought to the highest levels of the Commission, and in Congress, without being subject to the influence of the SEC staff and divisional directors. Institutional inertia and bias in favor of focusing efforts on the largest institutions must be overcome.

The Office of Small Business Policy will continue to have a complementary and critical role at the Commission, as it will continue to assist small businesses and small business investors seeking to navigate the regulatory requirements of setting up a Regulation A+ or equity crowdfunding offering, as well as assisting the SEC staff in drafting proposed rules and regulations, such as those under any future JOBS Act 2.0. In sum, the Office of Small Business Policy will be complementary to the Small Business Advocate office in that it will not be a policy creation and promotion office (like the Advocate), but an active implementor of the new proposals championed by the Advocate, the Committee and the Forum. It is far too easy and far too common that small business interests are pushed aside and permanently delayed in favor of issues focused on the very large instituions regulated by the SEC.

II. The Office of the Advocate for Small Business Capital Formation will Assist Horizon & Other Small Business Investors

A new Small Business Advocate office will be a significant help to Horizon and other small business investors that make up SBIA's membership. First, there are a number of current examples where an Advocate would be helpful to encourage the Commission to take action to encourage change to SEC rules that would promote small business capital formation. Second, the Advocate could have encouraged helpful changes to the JOBS Act rulemakings that could have assisted small business investors, such as Horizon, had they been implemented. Finally, the new permanent Small Business Capital Formation Advisory Committee could and should include firms like Horizon that have an impact on small business investment.

C. The Office of the Advocate Could Assist in Making Regulatory Changes for BDCs and Advisers to Small Business Funds that Would Encourage Small Business Capital Formation

The Small Business Advocate would be helpful to BDCs, like Horizon, by raising regulatory issues and helping Congress draft legislation to modernize BDC regulations. For example, there are a number of offering reforms impacting BDCs that would greatly help the BDC capital raising process and make it more flexible, more efficient, and less expensive, while making little impact on investor protection and transparency. This year as Committee Members drafted and passed out of the Committee reforms that modernize the capital raising process for BDCs, the Advocate would have been an independent voice for the industry and more helpful to Congress as it drafted these reforms.

Similarly, many private fund advisers that invest in small business, including SBIA's members, have been faced with a burdensome registration regime, and investment adviser regulations designed for retail customers, rather than investing in small businesses. A Small Business Advocate, as proposed in this legislation, could be a champion for those small business fund advisers, to ensure that the rules they are following make sense for the type of investing they are engaged in.

D. The Office of the Advocate Could Encourage Changes to the JOBS Act that Assist Small Business Investors, including BDCs

In the final release of the regulations implementing the JOBS Act, a number of changes and issues remain that were not appropriately addressed by the Commission. For instance, the SEC chose in the final rulemaking, not to permit BDCs to utilize the new Tier 2 of Regulation A+. This is despite the fact that Regulation A+ would be useful for new "startup" BDCs seeking to raise capital before going public. These "startup" BDCs could be a useful way to raise capital to invest in small businesses, but are unable to use the new rule. A Small Business Advocate could raise these issues to the Commission in future rulemakings, and ensure that the potential for capital raising for small business investors would not be lost. BDCs should also have a role on the Small Business Capital Formation Advisory Committee, given the role Congress gave them in promoting investment in America's small businesses. The lack of a clear role on the Advisory Committee for BDCs should be remedied in H.R. 3784.

III. SBIA Supports the HALOS Act, Which Will Facilitate the Connection of Small Business Investors with Funds Deploying Capital Into Small Business

SBIA also supports the Helping Angels Lead our Startups Act ("HALOS Act"). This legislation helps address a problematic issue in the raising of private capital surrounding the definition of general solicitation, and the matching of investors with startup investment opportunities. A number of trade organizations in the private equity and small business investor space face similar issues to the venture and angel community, in facilitating the meeting of potential limited partner investors (institutional and accredited investors), and general partner investment managers. Unfortunately, under the Rule 506(b) private placement exemption in Regulation D, one may run afoul of the exemption if a manager of a small business fund does not have a substantive, preexisting relationship with the potential investor. There is significant lack of clarity about what constitutes a substantive preexisting relationship. The HALOS Act provides essential protection for trade associations that facilitate such meetings between investors and fund managers, and would be greatly helpful in cultivating small business capital formation. More importantly, it provides protection for fund managers engaged in meeting potential investors at these events. SBIA encourages the Committee to pass this legislation to provide associations like SBIA and our fund manager members the protection they need.

IV. SBIA Supports The Small Business Capital Formation Enhancement Act

This legislation, put forward by Representative Poliquin, would provide a needed update to the annual Government-Business Forum on Small Business Capital Formation at the SEC. As highlighted previously in our testimony, this Forum results in many helpful suggestions on changes that can be made in the securities rules. However, the suggestions are often left for dead and not acted upon at the SEC. Congressman Poliquin's legislation would require the SEC to respond in a public statement to each of these suggestions, ensuring that the SEC acknowledges the receipt of these suggestions, and explains why they will adopt or not adopt these suggestions. SBIA strongly supports the passage of this legislation.

Statement of the U.S. Chamber of Commerce

ON: Legislative Proposals to Improve the U.S. Capital Markets

TO: House Subcommittee on Capital Markets and Government Sponsored Enterprise

BY: Tom Quaadman, Senior Vice President, Center for Capital Markets Competitiveness

DATE: November 30, 2015

The U.S. Chamber of Commerce is the world's largest business federation representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Chairman Garrett, Ranking Member Maloney, and members of the Capital Markets and Government Sponsored Enterprises subcommittee—my name is Tom Quaadman, senior vice president of the Center for Capital Markets Competitiveness ("CCMC") at the U.S. Chamber of Commerce ("Chamber"). The Chamber is the world's largest business federation, representing the interests of more than three million businesses of all sizes, sectors, and regions. I appreciate the opportunity to testify before the subcommittee today on behalf of the businesses the Chamber represents.

The Chamber views a strong and fair Securities and Exchange Commission ("SEC") as a critical and essential element needed for efficient capital markets. Having a strong securities regulator is necessary for investors and businesses to have the certainty needed to transfer capital for its best use with an expectation of return. This allows market participants to engage in reasonable risk taking on a fair playing field.

While the SEC has traditionally been considered the premier securities regulator, in recent years its effectiveness has been questioned and its credibility has diminished—many factors have contributed. First, markets have fundamentally changed since the SEC was created during the Great Depression of the 1930's. Second, managerial challenges have created obstacles that have prevented the SEC from acquiring the appropriate expertise and deploying its resources for the best use, undercutting its ability to evolve with changing markets and overseeing them. Third, changes in enforcement practices, some of which have been helpful, have created fundamental issues of due process and fairness that are at the heart of any legal proceeding under our constitutional form of government. Finally, it has been difficult for the SEC to focus on all of the elements of its tripartite mission—promoting investor protection, facilitating capital formation and maintaining fair, orderly, and efficient markets.

Many, including the Chamber, have identified shortcomings in our financial regulatory structure that are making it harder for businesses to acquire the capital needed to grow and prosper. The Chamber released a report in 2007, the ***Report and Recommendations of the Commission on the Regulation of U.S. Capital Markets in the 21st Century***, and a report in 2011, the ***U.S. Capital Markets Competitiveness, the Unfinished Agenda***, to identify problems and the shortfalls of our current financial regulatory system and the drag this creates on the United States to compete in a global economy.

But the Chamber has also offered solutions. In 2009, we issued a report, ***Examining the Efficiency and Effectiveness of the U.S. Securities and Exchange Commission***, and in 2011, ***the U.S. Securities and Exchange Commission: a Roadmap for Transformational Reform,*** that contained 51 recommendations for managerial reforms and regulatory enhancements to help the SEC acquire the knowledge and expertise needed to better understand and oversee the markets and products it regulates. This past summer, the Chamber issued a new report, ***Examining U.S. Securities and Exchange Commission Enforcement: Recommendations on Current Processes and Practices*** ("Chamber SEC enforcement report"), that made 28 recommendations to improve SEC enforcement and due process.

The Chamber's SEC enforcement report reviewed the current practices of the SEC Enforcement Division, changes in strategy and practice by the SEC, the evolving use of administrative proceedings, and the adequacy of rules of practice. This was the culmination of almost two years of effort that included a survey of public company CEOs and general counsels, dozens of in-depth interviews with businesses, academics, former SEC enforcement officials, and meetings with many securities lawyers. The report recommended a review and changes in the rules of practice to make due process enhancements, creating a right of removal to district court under appropriate circumstances, improving the investigative process and strengthening the Wells process.

To their credit, the SEC has been moving forward on some of these recommendations. The SEC is integrating trial lawyers into the investigative process at an early stage. Similarly, the SEC has also put out for comment a review and changes of its Rules of Practice for administrative proceedings. This responds to a specific recommendation in our 2015 report. We will file a comment letter on this proposal later this week and will be happy to provide a copy to the Subcommittee. I will defer a more in-depth discussion of several of the issues regarding SEC enforcement in the discussion of H.R. 3798, the Due Process Restoration Act of 2015.

The Chamber has also been concerned about the SEC's focus on its mission of promoting capital formation and competition. Too often, the SEC had failed to keep its rules current, forcing Congress to step in. Accordingly, the Chamber has been supportive of the Subcommittee's efforts in these areas, including the Jumpstart Our Business Startups Act ("JOBS Act") and other legislative efforts including disclosure modernization, improving the process for private placements and use of business

development corporations. We support several of the bills that are the subject of this hearing and will discuss them in more depth.

1. H.R. 3798, the Due Process Restoration Act of 2015

As mentioned earlier, the Chamber has taken a long, hard look at SEC enforcement practices. A major concern raised during our work in this area was the increased and wide-spread use of administrative proceedings for enforcement cases.

Over the past few years, we have seen administrative proceedings being used as the primary means of the SEC prosecuting enforcement cases under its non-criminal powers. This has created an imbalance in the system that endangers the rights of defendants and undermines the use of appropriate enforcement tools, while raising important questions regarding the separation of powers between the executive and judicial branches of government.

I want to bring to your attention two Wall Street Journal op-eds that address these issues.[1] The first one, by Russell Ryan, a former assistant director of enforcement at the SEC, raises questions regarding the increased use of administrative proceedings in a quasi-criminal manner. The second, by Nelson Obus, founding partner of Wynnefield Capital, describes a case that stretched over 12 years because of its consideration at both the administrative level and in District Court. However, because the case was ultimately decided in a District Court where greater due process was afforded, the defendant was acquitted. Today, that case would not have a path to go straight to District Court. If Mr. Obus had been required to litigate in an administrative proceeding, he would have been denied the opportunity to use pre-trial discovery to uncover the evidence that led to his acquittal.

While administrative proceedings allow for a speed of resolution, some have raised issues that it provides the SEC with an advantage because the rules of discovery, right of deposition and motion practice are severely restricted or non-existent in an administrative proceeding as compared to a case litigated in district court.

It should be remembered that certain cases should only go through an administrative proceeding, such as stop order proceedings or license revocations.

[1] The Wall Street Journal Op-eds are from August 4, 2014 and June 24, 2014 and can be found at: http://www.wsj.com/articles/russell-g-ryan-the-sec-as-prosecutor-and-judge-1407195362 and http://www.wsj.com/articles/nelson-obus-refusing-to-buckle-to-sec-intimidation-1403651178.

However, more serious cases should, within certain parameters, allow a defendant the option to remove a proceeding to District Court.

The SEC has also started to redress some of the issues through its current review of the rules of practice. However, we believe that these proposed changes do not go far enough. In fact, we will make the following suggestions to the SEC later this week to expand the scope of procedural changes including:

1. The proposed amendments to rule 233 on the use of depositions are insufficient to provide respondents with meaningful discovery.

2. The proposed amendments to rule 230(a) on document production should require enforcement staff to promptly provide a list of all persons interviewed and/or deposed during the investigation.

3. The proposed amendments should permit an ALJ to extend the time available for pre-trial process for proceedings in which the staff has compiled a huge documentary record.

4. A clear standard governing the use of hearsay testimony should be adopted that is consistent with the standard proposed for deposition testimony.

5. The proposed amendment to rule 230(b) enabling staff to withhold or redact documents reflecting settlement negotiations should also prohibit staff from introducing Wells submissions or white paper as evidence in an administrative proceeding.

6. The proposed amendment of rule 900 that extends the time period for completion of the Commission's review exacerbates a long-standing problem.

7. The proposing release does not discuss the important issue of choice of venue.

8. The proposed rule changes affect substantive and material rights of all persons named in an administrative proceeding and do not qualify for exemption from the notice and comment requirements of the Administrative Procedure act.

The failure to discuss the right of removal question is a glaring and unfortunate omission in the SEC proposal. The American system of jurisprudence has always provided the defendant with the right to request a jury trial. The current SEC system provides the prosecutor, the SEC Division of Enforcement, with exclusive control over the request for a jury trial. For more serious offenses, we believe that a defendant, not the government should have the ability to decide if they should preserve their right to a jury trial.

We believe that the Due Process Restoration Act of 2015 is an important step forward in restoring the balance between the appropriate uses of administrative proceedings and preserving the due process rights of defendants. This bill, if passed, would allow defendants, within parameters, to have the option to take a case to district court. We believe this bill would allow for the SEC to use administrative proceedings as they have been used historically, while allowing defendants all available options. If the SEC rules of practice are amended to allow for a fair process of discovery, administrative proceedings would be a fair and level playing field. The right of removal would not, in our opinion, burden court dockets.

Nevertheless, we believe that certain amendments are needed for the Due Process Restoration Act of 2015 to achieve its intent.

First, the legislation should amend the 1933 Exchange Act, the Investment Company Act, and the Investment Advisors Act of 1940. As currently drafted, the bill only amends the 1934 Exchange Act and therefore only be applicable to a narrow band of cases. By expanding the scope of this bill to include the 1933 Exchange Act, the Investment Company Act, and the Investment Advisors Act of 1940, it would ensure that the same right to a district court proceeding would be applicable for all major enforcement matters.

Second, the Chamber has concerns about the use of a clear and convincing standard through a right of removal process. This would create different levels of a burden of proof that would create an uneven-playing field. The burden of proof should be the same in an administrative proceeding or a district court case. While we understand the thought behind the use of a clear and convincing standard, this can have unforeseen consequences that may not help defendants or appropriate enforcement activities.

The Chamber believes that the passage of the Due Process Restoration Act of 2015, with our suggested amendments, as well as expanded changes to the SEC's rules of practice, would allow for both fair due process and strong enforcement policies. This will be a two pronged approach necessary for efficient capital markets.

2. H.R. 3784, the SEC Small Business Advocate Act of 2015

The Chamber supports the passage of the Small Business Advocate Act of 2015, and thanks Mr. Carney, Mr. Duffy, Mr. Quigley, and Mr. Crenshaw for its introduction. Attached with this testimony is a copy of a letter by a coalition of business and investor trade associations supporting passage of this legislation.

Nevertheless, the Chamber believes that the Small Business Advocate Act of 2015 should be amended in two ways.

First, the bill allows for small business advocate to be on the same plane as the investor advocate. Accordingly, the small business advocate should be given the same powers to consult with the investor advocate, as the investor advocate is given to consult with the small business advocate. As such, this bill should be amended to have the Investor Advocate consult with the Small Business Advocate for any proposed changes it may make. The bill should also be amended to allow for the small business advocate to appoint a non-voting member to the investor advisory committee.

Second, the Chamber has consistently advocated that advisory committees of the SEC, or its subordinate organizations, be subject to appropriate levels of transparency and accountability and subject to the Sunshine Act and the Federal Advisory Committee Act ("FACA").[2] In its current form, the Small Business Capital Formation Advisory Committee is exempt from FACA, as the Investor Advisory Committee currently is. We recommend this bill be amended to place the Small Business Capital Formation Advisory Committee, the Investor Advisory Committee, as well as Investor Advisory Group of the Public Company Accounting Oversight Board ("PCAOB") be placed under the jurisdiction of FACA.

3. Discussion Draft of the Small Business Capital Formation Enhancement Act

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[2] As an example, see the attached letter of October 7, 2009 to the PCAOB on transparency and the Investor Advisory Group.

The Chamber appreciates the work of Mr. Poliquin for putting forth this discussion draft. The SEC has been slow, at best, to modernize regulations to meet the current needs of investors and businesses to compete and acquire capital. Too often, regulatory structures remain stagnant over the course of decades while the marketplace is constantly evolving. In fact, the proactive efforts by this subcommittee and Congress in passing the JOBS Act and other bills to advance capital formation are directly related to the inertia of the SEC to modernize regulations.

The Small Business Capital Formation Enhancement Act would help to overcome the inertia of the SEC and take the initiative in modernizing regulations. Many of the initiatives encompassed in the JOBS Act were first identified and proposed by the forum on small business capital formation. This bill would require the Commission to pay closer attention to the forum and take affirmative action to move forward or not. Therefore, the needs of capital formation cannot simply be ignored.

The Small Business Capital Formation Enhancement Act may be a small step, but it is an important step forward to help the SEC stay connected to a changing market place and provide the structures needed to meet the needs of investors and businesses.

4. **Discussion Draft of the Helping Angels Lead Our Startups Act ("HALOS Act")**

The Chamber appreciates the work of Mr. Chabot, Ms. Sinema, Mr. Hurt, and Mr. Takai in drafting the HALOS Act. We support the intent of this bill to expand the role of angel investing in assisting start-up businesses to acquire the financing needed to grow. We believe that the increase of information in the marketplace is an important step forward in expanding the use of angel investing, provided that such information is directed at accredited investors and is accompanied by appropriate investor protections.

The Chamber has consistently urged the SEC to review all of its rules with the broader goal of removing rules or disclosures that no longer fulfill their intended purpose or where the costs of the rule outweigh any intended benefit. Such a review should take several forms. For disclosures to investors, the SEC should consider whether the disclosure provides investors with information useful in making investment decisions, or whether the disclosure become obsolete with irrelevant

clutter that investors must sift through. Obsolete disclosures deter investors from reviewing disclosures, and may negatively impact the investors' decision making matrix, while also making the investor less productive. Additionally, a retrospective cost benefit analysis would help the SEC and market participants to understand if the new rules are benefiting the marketplace, or heaping unneeded costs upon businesses and ultimately their investors.

We raise this analysis in the context of this legislation since these circumstances present the perfect opportunity to put in place a retrospective review of this change in information distribution. Commitment to perform such a review would allow the SEC and market participants to know by a date certain if the advertising permitted by the final rule is assisting capital formation, if the benefits outweigh the costs and if the investor protections are sufficient.

We believe that such a retrospective review should be added to this bill to have the SEC provide the information needed for all stakeholders to understand if the HALOS Act is a positive for both capital formation and investor protection, or if more needs to be done.

5. Conclusion

The Chamber views these bills, along with our proposed improvements, as important steps to provide for appropriate regulatory structures and to meet the needs of a dynamic marketplace.

Passage of the Due Process Restoration Act of 2015 would allow for a fair and due process that allows for the SEC to prosecute wrong-doers and for defendants to protect themselves. We believe that capital formation and competition would be well served through the three prong approach of the SEC Small Business Advocate Act of 2015, Small Business Capital Formation Enhancement Act and the HALOS Act.

We ask that the subcommittee and House consider these bills expeditiously and include them in a JOBS Act 2.0 to provide American businesses with the capacity to access the resources needed to compete, thrive and create jobs.

I am happy to take any questions that you may have at this time.

Stanford Law School

Joseph A. Grundfest
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December 8, 2015

Congressman Scott Garrett
2232 Rayburn House Office Building
Washington, DC 20515

Re: Clarification of the record for Hearings Related to H.R. 3798, The Due Process Restoration Act of 2015, Dec. 2, 2015

Dear Chairman Garrett:

At the recent hearings on H.R. 3798, the Due Process Restoration Act of 2015, concern was expressed regarding potential adverse effects of removal legislation on the Securities and Exchange Commission's ability promptly to shut down frauds that continue to damage investors. It bears strong emphasis that removal legislation will have no effect on the Commission's ability promptly and effectively to shut down ongoing frauds, or to obtain other forms of prejudgment relief.

Concern was also expressed that removal legislation might have prevented the Commission from quickly shutting down Bernie Madoff's massive Ponzi scheme. Again, removal legislation would have had no effect on the Commission's ability quickly to terminate Madoff's operations.

Indeed, I would oppose any legislation that would impair the Commission's ability to respond quickly and effectively to illegal conduct that continues to victimize innocent investors. I can support removal legislation because it has no such effect.

When the Securities and Exchange Commission requires rapid, prejudgment relief in order to protect investors, to prevent assets from leaving the jurisdiction, or to preserve evidence, it proceeds in federal court and seeks a temporary restraining order or other form of emergency relief. As the Commission's Director of the Division of Enforcement recently explained, "only a federal district court can issue the necessary emergency relief to protect investors."[1]

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[1] Sec. & Exch. Comm'n, SEC Division of Enforcement Approach to Forum Selection in Contested Actions (May 8, 2015), https://www.sec.gov/divisions/ enforce/ enforcement-approach-forum-selection-contested-actions.pdf ("In situations where there is a need for emergency proceedings or relief – where the alleged violative conduct is ongoing and/or there is a risk that proceeds of the alleged wrongdoing will be dissipated or moved offshore or evidence will be destroyed – only a federal district court can issue the necessary emergency relief to protect investors, such as a temporary restraining order, asset freeze, and/or a document preservation order."); See also, Andrew Ceresney, Keynote Speech at New York City Bar 4th Annual White Collar Institute (May 12, 2015) ("[I]f we need prejudgment relief – like the TROs and asset freezes I talked about earlier - only a federal district court can grant this type of relief.").

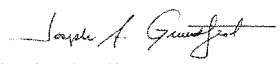
The Commission does not resort to its internal administrative procedures in order to seek emergency relief to protect investors. Instead, the path from the SEC to the federal courthouse is well worn, and there are many recent examples of the Commission successfully proceeding in federal court to shut down ongoing frauds so as to prevent continuing investor harm.[2]

As for Mr. Madoff, he was arrested by FBI agents because of information provided to federal authorities by his sons. Mr. Madoff's crimes were not independently discovered by the Securities and Exchange Commission or by any other government body. Further, the SEC has no authority to arrest or detain any person for any reason. It took a federal court order to shut down Mr. Madoff's business operations, and SEC administrative proceedings played no role in that process.[3] The procedure by which Mr. Madoff's operations were shut down is thus entirely consistent with the description provided by the Director of the SEC's Enforcement Division: the Commission, and the Department of Justice, turned to the federal courts and not to the SEC's internal administrative proceedings in order to obtain summary relief.

Because removal legislation only implicates matters that are first filed as administrative proceedings, and because the Commission does not employ administrative proceedings when it seeks emergency relief, it follows that removal legislation cannot adversely affect the Commission's ability to obtain emergency relief in any form.

I hope that these observations are useful clarifications of the record.

Sincerely,



Joseph A. Grundfest

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[2] *See, e.g., S.E.C. v. Madoff, et al.*, No. 08 Civ. 10791, slip op. at (S.D.N.Y. Dec. 12, 2008) (order granting temporary restraining order, asset freeze, and other relief); *see also S.E.C. v. Interinvest Corporation, Inc. et al.*, Litig. Release No. 23288 (June 17, 2015) (announcing action for emergency relief filed against an investment advisory firm in federal district court); Press Release, *SEC Freezes Assets in Ponzi Scheme Targeting Investors in Japan* (Sept. 26, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539844572 (noting that in September 2013, the SEC obtained an *ex parte* TRO in federal district court halting a $442 million Ponzi scheme and freezing the assets of Edwin Fujinaga); Press Release, *SEC Shuts Down $600 Million Online Pyramid and Ponzi Scheme* (Aug. 17, 2012).

[3] See, e.g., Amir Efrati, Tom Lauricella, and Dionne Searcey, *Top Broker Accused of $50 Billion Fraud*, Wall Street Journal, Dec. 12, 2008.



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December 2, 2015

Scott Garrett
Chair
Carolyn Maloney
Ranking member
House Subcommittee on Capital Markets and Government Sponsored Enterprises of the Committee on Financial Services

Dear Chair and Ranking Member,

On behalf of more than 400,000 members and supporters of Public Citizen, we offer our views on the bills that are the subject of the Dec 2, 2015 hearing before the Capital Markets and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee on "Legislative Proposals to Improve the U.S. Capital Markets."

Generally, we believe these bills begin with a premise that investor protections should be a secondary consideration for the Securities and Exchange Commission, and that they should be subordinated—even in cases of alleged issuer misconduct—in the service of promoting capital formation. We believe this premise is misguided. The primary mission of the SEC is investor protection. Capital formation proceeds from investors who can trust those who sell securities. Excusing issuers from proven investor protection requirements invites mischief. In the end, a market untrusted by investors will not serve issuers and the broader economy.

We address the bills individually below:

SEC Small Business Advocate Act (HR 3784)

Public Citizen opposes HR 3784 because it subordinates the SEC's mission to protect investors.

HR 3784 would establish within the SEC an Advocate for Small Business Capital Formation and a Small Business Capital Formation Advisory Committee, similar to Section 915 of the Dodd-Frank Act where the SEC's Office of the Investor Advocate was established, and Section 911 of Dodd-Frank which established the SEC Investor Advisory Committee.

Public Citizen supports agency interaction with the public generally and with those affected directly by agency decisions, including small busineses. We are skeptical, however, of the need for a mechanism by which small business interests can express their views about SEC regulations. While we know many enlightened small business managers who understand the need for well-regulated markets, we're aware of others that become pawns for deregulation. Our skepticism is informed by our experience with the U.S. Chamber of Commerce. We believe this organization claims to represent the interests of small business, but actually speaks for some of the largest business in the United States whose interests may be very different than those of Main Street.

The bill provides that the advisory committee be comprised of officers and directors of smaller companies, professional advisors to these companies, and a few investors in these companies. This composition assumes that where there may be disagreement between issuers and investors, the issuers prevail.

Perhaps most importantly, the SEC already provides a forum for the voices of small business, namely an Office of Small Business Policy within the Division of Corporation Finance, and an Advisory Committee on Small and Emerging Companies. An additional committee would be duplicative.

This bill stems from the assumption that worthy small businesses lack access to capital and with a more robust advocate within the SEC that circumstance would change. However, the facts do not support this. JP Morgan has more than $300 billion worth of deposits for which it has not been able to identify creditable small business borrowers. Silicon Valley is awash in venture capital. Our economy struggles, but that's because regulation and regulators of Wall Street proved inadequate, leading to reckless allocation of capital to those who ultimately could not shoulder the debt.

Due Process Restoration Act of 2015 (HR 3798)

HR 3798 would give defendants subject to SEC proceedings before an Administrative Law Judge (ALJ) the option to have those proceedings terminated and brought instead in U.S. District Court. The bill also provides that for those proceedings heard before an ALJ, the

burden of proof would be raised from the current "preponderance of the evidence" standard to a higher "clear and convincing evidence" hurdle.

Generally, Public Citizen supports a citizen's right to Article 3 protections in federal court. At the same time, we believe that Wall Street misconduct is so rampant that Congress should be looking for ways to strengthen the powers of law enforcement authorities rather than weakening them. SEC enforcement authority is not only crucial to holding bad actors on Wall Street accountable; it is also the primary deterrence to skirting of laws and regulations by Wall Street that directly harms investors on Main Street. For a public rightly concerned with the general integrity of Wall Street, this bill sends the wrong message. Raising the burden of proof will only frustrate the effort to bring lawfulness back to our securities markets.

Additionally, while the concerns over lack of due process regarding SEC administrative adjudication hold little merit, Congress, and this committee in particular, should take action to address the significant and well documented due process concerns regarding the widespread use of forced arbitration clauses by financial firms in contracts with investors and customers. Whereas parties subject to enforcement actions by the SEC are fully able to bring their case before a SEC ALJ and then to a federal court if unsuccessful before an ALJ, investors or customers aggrieved by actions of financial firms are blocked from even making it into the courthouse doors at all if subject to forced arbitration. Rather than wasting time on fabricated lack of due process claims for big Wall Street banks, this committee should be focusing on protecting Main Street from mandatory arbitration provisions that eviscerate their due process rights.

Helping Angels Lead Our Startups Act (not yet numbered)

The HALOS Act would lift restrictions on selling securities under Rule 506 of Regulation D to several new classes of investors, including governmental entities, a college or university, or nonprofit associations. Many of these may be unsophisticated investors. We oppose the inclusion of these new classes.

Fostering Innovation Act of 2015 (not yet numbered)

This bill would allow firms with as much as $700 million worth of stock held by investors to escape an audit of their controls over financial reporting for as long as 10 years.

Public Citizen believes firms that sell stock to the public should be able and willing to prove to an auditor that they understand and control their own business. Certainly a firm with sales of more than $1 billion, which is a parameter in this legislation, should be able to face

such scrutiny. Even smaller firms that hope to finance themselves with other people's money must be willing to account for themselves. The Jumpstart our Business Startups Act already provides ample exemptions for smaller businesses.

Small Business Capital Formation Enhancement Act (not yet numbered)

The Small Business Capital Formation Enhancement Act would require the SEC to review and respond to the findings and recommendations of the Forum on Capital Investment. Rather than an act of Congress, we suggest that the committee chair might make this request of the SEC chair in a letter.

For questions, please contact financial policy advocate Bartlett Naylor at bnaylor@citizen.org, or regulatory policy advocate Amit Narang at anarang@citizen.org.

Sincerely

Public Citizen

WRITTEN STATEMENT OF

JENNIFER TAUB
PROFESSOR OF LAW
VERMONT LAW SCHOOL

FOR THE UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

"LEGISLATIVE PROPOSALS TO IMPROVE THE U.S. CAPITAL MARKETS"

DECEMBER 2, 2015
10:00 AM

Author Background Statement

Jennifer Taub is a Professor of Law at Vermont Law School where she teaches courses in contracts, corporations, securities regulation, and white-collar crime. She earned a J.D. *cum laude* from Harvard Law School, and a B.A. *cum laude* from Yale College.

Prior to joining VLS, Professor Taub coordinated the business law program at the University of Massachusetts, Amherst Isenberg School of Management. She has been appointed a Visiting Fellow at the Yale School of Management for the spring 2016 semester.

Formerly an Associate General Counsel at Fidelity Investments, Professor Taub's research and writing focuses on corporate governance and financial market regulation. Her financial crisis book, *Other People's Houses: How Decades of Bailouts, Captive Regulators, and Toxic Bankers Made Home Mortgages a Thrilling Business* was published in 2014 by Yale University Press. In 2015, *Other People's Houses* was named a "Massachusetts Must Read" by the Massachusetts Center for the Book.

Chairman Garrett, Ranking Member Maloney and distinguished members of the Subcommittee, I appreciate the opportunity to submit this statement to the United States House of Representatives Committee on Financial Services for inclusion in the record of the hearing entitled, "Legislative Proposals to Improve the U.S. Capital Markets," scheduled for December 2, 2015 by the Subcommittee on Capital Markets and Government Sponsored Enterprises.

My name is Jennifer Taub. I am a Professor of Law at Vermont Law School where I teach business law courses including contracts, corporations, securities regulation, and white-collar crime. I submit my statement today solely as an academic and not on behalf of my law school or any other entity.

For reasons set forth below, I believe that at least two of the legislative proposals you are considering will damage, not improve, the U.S. capital markets. Of particular concern are the Due Process Restoration Act (H.R. 3798) and the Fostering Innovation Act. These proposals may seem appealing on the surface. Like masterful marketing slogans for mediocre products, their titles and descriptions are designed to persuade but not fully inform. At first glance, sensible people would support both *restoring due process* and also *fostering innovation*. But, upon digging deeper into the details, they will note that due process has not been taken away from parties to SEC administrative hearings. And, depriving for a decade, shareholders of companies with between $75 million and $700 million in common stock of auditor attestations—related to internal control over financial reporting—will not foster innovation.

In other words, these bills are premised on imagined or exaggerated problems in order to slide through solutions that cause more harm than good. Misleading techniques of this type are known in the false advertising realm as "bait and switch" tactics. Similarly, these legislative proposals will not actually deliver as promised. Instead, they will weaken one of the central pillars of the U.S. capital markets, the protection of investors.[1]

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[1] Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Speech at the 2015 Consumer Federation of American Annual Conference: Seeing Capital Markets Through Investor Eyes (Dec. 5, 2013) ("Unfortunately. . .when many say capital formation, what they mean is simply capital-raising. That's the wrong goal. The singular act of raising capital does not necessarily result in capital formation—for example, whatever makes it easier and cheaper for issuers to raise money

I. The Due Process Restoration Act (H.R. 3798)

The title given to H.R. 3798 -- the "Due Process Restoration Act" is a misnomer.[2] A more apt one would be the "Securities Law Defendant Special Treatment Act." With this bill, Congress would grant special rights to defendants including to force the Securities and Exchange Commission to bypass the administrative process and file all contested claims in federal district court. The bill purports to "restore" due process to parties in administrative proceedings brought by the SEC. However, due process rights have not been taken away. Any party who is dissatisfied with the outcome can appeal to federal circuit court.[3]

Presumably, H.R. 3798 is a reaction to the claim that the SEC has an unfair "home court" advantage when it brings contested cases through the administrative process instead of through the federal courts.[4] Yet, two federal circuit courts have

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does not necessarily increase the rate of capital formation—and, in fact, can be detrimental to capital formation. In my five years as a Commissioner, I have considered countless enforcement recommendations that involve some very good capital raisers who raised millions of dollars through fraudulent means. Unfortunately, these fraudsters ended up destroying the capital they raised, rather than putting it to work toward economic growth. ")

[2] Peter J. Henning, *Reforming the S.E.C.'s Administrative Process*, N.Y. TIMES DEALBOOK, Oct. 26, 2015 ("The bill's title, claiming to restore due process to administrative proceedings, gives the impression that the S.E.C. somehow corrupted the system by surreptitiously sending cases before its judges with the goal of subverting the rights of defendants. But that is hardly the case because it was Congress that created the process for administrative agencies to adjudicate matters, something done throughout the federal government;") available at http://www.nytimes.com/2015/10/27/business/dealbook/reforming-the-secs-administrative-process.html

[3] In contested cases, typically after a public hearing, the ALJ makes an initial decision. A party can appeal this initial decision to the five commissioners who can either adopt the decision or perform a de novo review. Upon review, the Commission can affirm the initial decision, modify it, reverse it, set it aside, or remand it for further proceedings. A party not satisfied with the outcome of the Commission's review can then appeal to a U.S. Court of Appeals.

[4] This view emerged after the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") expanded the cases that could be brought through the administrative process. According to one study, since 2010, the SEC has prevailed in 86% of the contested cases in its own tribunal compared to 70% in federal court. However, the same study shows that win rate has recently changed. For this year, through September 30th, the SEC has only won 50% of contested cases before administrative law judges. *See,* Jean Eaglesham, *Fairness of SEC Judges is in the Spotlight*, WALL ST. J., Nov. 22, 2015.

already affirmed federal district court's decisions to reject hearing due process challenges to the SEC's existing practices.[5] Nevertheless, in response to criticism,[6] the SEC has prudently proposed for public comment amended rules governing its administrative proceedings.[7] The proposed rules would provide a more generous time frame and would allow parties to take depositions, among other changes.

Simply put, while some improvements to the SEC's administrative process rules are desirable, H.R.3798 goes too far. If enacted, any party (who is not interested in settling) could unilaterally require the SEC to terminate an administrative proceeding.[8] The administrative case would close, but the SEC would then be permitted to initiate a new civil action against the defendant in federal court. The bill would also give new, favorable treatment to parties who choose to continue to contest the case in an administrative proceeding. The SEC would face a higher burden of proof than the current preponderance of the evidence standard.[9] The SEC would have to show by "clear and convincing evidence" that the person "violated the relevant provision of law." The imposition of this different, higher burden of proof would also pressure the SEC to initiate more cases before federal court judges and not before administrative law judges.

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[5] See *Bebo v. SEC,* 799 F.3d 765 (7th Cir. 2015) (Affirming the District Court's decision granting "the SEC's motion to dismiss for lack of subject matter jurisdiction, holding that the administrative review scheme established by Congress stripped it of jurisdiction to hear this type of challenge;") and *Jarkesy v. SEC*, 803 F.3d 9 (D.C. Cir. 2015) (Affirming the District Court's conclusion that "Congress, by establishing a detailed statutory scheme providing for an administrative proceeding before the Commission plus the prospect of judicial review in a court of appeals, implicitly precluded concurrent district-court jurisdiction over challenges like" this one).

[6] Barry R. Goldsmith, *SEC Proposed Amendments to Rules for Administrative Proceedings*, HARV. L. FORUM ON CORP. GOV. & FIN. REG., Oct. 15, 2015 ("the SEC continues to face serious criticism—in the media and from lawyers, academics, and federal courts—that the rules governing the SEC's in-house court system fail to afford respondents a full and fair opportunity to defend themselves.")

[7] *See* Amendments to the Commissions Rules of Practice, Securities Exchange Act Release No. 75,976, 80 Fed. Reg. 60,091 (Oct. 5, 2015) (purpose of proposed rule includes to "adjust the timing of hearings in administrative proceedings; allow for discovery depositions; clarify the rules for admitting hearsay and assertion of affirmative defenses; and make certain related amendments.")

[8] The only limitation on this power to require the SEC to terminate would be temporal; the party would have twenty (20) days after receiving notice of the proceeding to make the termination demand.

[9] Section 556(d) of the Administrative Procedures Act describes the burden of proof as "in accordance with the reliable, probative, and substantial evidence."

If passed, H.R. 3798 would undermine the SEC's ability to swiftly impose cease and desist orders and penalties on, require disgorgement of ill-gotten gains from, and obtain restitution for victims of those who have harmed investors in violation of federal securities laws. Cases initiated in federal court by the SEC can drag on for years. In contrast, a hearing before an administrative law judge takes place within months after the SEC institutes the proceeding, and the entire proceeding is done in less than a year.

In addition, this bill would create unclear precedent. Cases heard by administrative law judges would be subject to the "clear and convincing" standard. However, those cases initiated by the SEC in federal court even when applying the same laws and regulations would be subject to the lower preponderance of the evidence standard. This would result in confusing precedent when the same statutes and rules are interpreted under different standards.[10]

II. Fostering Innovation Act of 2015

The "Fostering Innovation Act" is also misnamed, unless the innovation to be fostered is creative accounting schemes leading to restatements and investor losses. This bill would amend the Sarbanes-Oxley Act to deprive investors who own shares in publicly-traded corporations (with relatively low revenue) some important protections against inaccurate or fraudulent financial reports.

It would allow companies in which shareholders together own between $75 million and $700 million in common stock to dodge important investor protections. For ten years after going public, these businesses with up to $50 million in gross revenue could avoid providing shareholders with meaningful assurance that the company financial reports are reliable. Specifically, the proposed legislation would exempt these issuers from the requirements of 404(b) of Sarbanes-Oxley. This section of the law requires a company's auditors to attest to and report on the manager's assessment of the company's internal control structure and the procedures for financial reporting.

[10] This is already a challenge to statutory construction when the same laws and rules are interpreted in the criminal and civil context. See Jed S. Rakoff, Speech at Conference on Corporate Crime and Financial Misdealing: Hybrid Statutes -- A Study in Uncertainty, NYU Law School, April 17, 2015. The problem is compounded if we were to add a third standard.

While it purports to focus on creating an exemption from 404(b) for small businesses this is not actually the case. Small businesses already have this exemption; which was codified in 2010 with the passage of the Dodd-Frank Act. Dodd-Frank created Section 404(c) of Sarbanes-Oxley which exempts issuers with less than $75 million in shares held by the public from the auditor attestation requirement.[11] As a result, 60 percent of reporting issuers are exempt from 404(b).[12] Using "low-revenue" of $50 million as a proxy for insignificance is ill-advised, as the shareholders who have collectively up to $700 million at stake, depend upon the accuracy of the financial reports and soundness of internal controls even if the company is growing.

Notably, the accounting profession supports the attestation requirement under 404(b) even for those small issuers who are exempt. The American Institute of CPAs website states that: "The AICPA has consistently urged implementation of Section 404(b) for all publicly held companies" because it "has led to improved financial reporting and greater transparency."[13] In addition, a 2013, the GAO found that from 2005 through 2011, a greater percentage of companies not required to comply with the auditor attestation requirement restated their financial than did those required to comply.[14] Also, academic studies have shown that compliance with Section 404 improves audit quality,[15] that strong internal controls are associated with better management forecasts, and that poor internal controls are associated with higher costs to raise equity and debt.[16]

Today's proposal is an unnecessary and harmful expansion of existing law. Under the Jumpstart Our Business Startups Act ("JOBS Act") passed in 2012, those less than $1 billion in annual gross revenue businesses known as "emerging growth companies," were granted the right to avoid the attestation requirement for up to five years after going

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[11] Only issuers known as accelerated filers (those with between $75 million and $700 million common equity not held by affiliates) and large accelerated filers (those with more than $700 million in common equity not held by affiliates) must comply.

[12] *See* Public Float Report, *infra* note 17 at 9.

[13] See the American Institute of CPAs website, "Section 404(b) of the Sarbanes Oxley Act of 2002," available at http://www.aicpa.org/advocacy/issues/pages/section404bofsox.aspx

[14] U.S. Gov't Accountability Office, Internal Controls: SEC Should Consider Requiring Companies to Disclose Whether They Obtained an Auditor Attestation 12 (July 2013), available at http://www.gao.gov/assets/660/655710.pdf

[15] See, e.g. Albert L. Nagy, *Section 404 Compliance and Financial Reporting Quality*, 24 ACCOUNTING HORIZONS 441 (September 2010).

[16] See summary of literature in Hongmei Jia, Hong Zie & David Ziebart, *An Analysis of the Costs and Benefits of Auditor Attestation of Internal Control over Financial Reporting*, Oct., 2015.

public. Generally speaking, this exemption from attestation would last the full five years so long as the common stock remained worth less than $700 million. The bill before you today seeks to extend that exemption up to a full decade.

Based on a report provided to Congress in 2011, such an extension would put investors at great risk without a commensurate benefit. With Section 989G(b) of the Dodd-Frank Act, Congress required the SEC to "conduct a study to determine how" it could "reduce the burden of complying with section 404(b)" for those "companies whose market capitalization is between $75,000,000 and $250,000,000." Dodd-Frank added that: "The study shall also consider whether any such methods of reducing the compliance burden or a complete exemption for such companies from compliance with such section would encourage companies to list on exchanges in the United States in their initial public offerings."

In April 2011, the staff of the SEC Office of Chief Accountant produced the study and recommendations.[17] To conduct the study, the staff gathered information about a population of issuers subject to 404(b); reviewed academic and other research, which included hundreds of studies and research papers concerning 404; and considered responses from a request for public comment. The more than 100-page report set forth many findings including regarding the effectiveness of 404(b). It found that those companies required to have an auditor attestation "generally had a lower rate of restatement than issuers that did not have such a requirement."[18]

Contrary to the argument that compliance is too costly,[19] the report concluded that: "The costs of Section 404(b) have declined since the Commission first implemented the requirements of Section 404, particularly in response to the 2007 reforms; Investors generally view the auditor's attestation on ICFR [internal control over financial

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[17] Sec. & Exch. Comm'n, Office of Chief Accountant, Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between $75 and $250 Million [hereinafter "Public Float Study], *available at* http://www.sec.gov/news/studies/2011/404bfloat-study.pdf

[18] *Id.* at 39.

[19] While auditor attestation has met objections as managers report that it increases their costs, however, a recent survey by the Financial Executives Research Foundation revealed that nearly half of respondents (including those that voluntarily comply) "indicated that they have better internal controls and that the additional expense was worthwhile." Financial Executives Research Foundation, 2015 Audit Fee Report at 4.

reporting] as beneficial; Financial reporting is more reliable when the auditor is involved with ICFR assessments; and There is not conclusive evidence linking the requirements of Section 404(b) to listing decisions of the studied range of issuers."[20] The report also concluded that "the United States has not lost U.S.-based companies filing IPOs to foreign markets for the range of issuers that would likely be in the $75-$250 million public float range after the IPO."[21]

The report recommended that "existing investor protections for accelerated filers to comply with the auditor attestation provisions of Section 404(b) should be maintained (i.e., no new exemptions)."[22] This subcommittee should heed this well-informed recommendation.

III. Conclusion

For the reasons set forth in this statement, I believe these two legislative proposals, the Due Process Restoration Act (H.R. 3798) and the Fostering Innovation Act, place investors at increased risk without providing commensurate benefits.

[20] *Id.* at 7.
[21] *Id.* at 4
[22] *Id.* at 8 (It also noted that "There is strong evidence that the auditor's role in auditing the effectiveness of ICFR improves the reliability of internal control disclosures and financial reporting overall and is useful to investors. The Staff did not find any specific evidence that such potential savings would justify the loss of investor protections and benefits to issuers subject to the study, given the auditor's obligations to perform procedures to evaluate internal controls even when the auditor is not performing an integrated audit.)



CENTER FOR CAPITAL MARKETS
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October 7, 2009

The Honorable Daniel L. Goelzer
Acting Chairman
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Dear Acting Chairman Goelzer:

The United States Chamber of Commerce ("Chamber") is the world's largest business federation representing more than 3 million businesses and organizations of every size, sector, and region. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy.

The CCMC recognizes the vital role of external audits in our markets and supports efforts to maintain and improve audit effectiveness. The Public Company Accounting Oversight Board (the "PCAOB") recently announced the formation of an Investor Advisory Group (the "IAG") and the appointment of 19 members to that body.

We strongly agree that the PCAOB should consult with and have transparent access to a full range of perspectives among all users of financial statements. The Standing Advisory Group has been one mechanism the PCAOB has used to formally receive input from the full spectrum of views. However, the PCAOB's ultimate responsibility is to ensure that its standards benefit ALL users of financial statements.

As such, the CCMC has very serious concerns surrounding the creation of the IAG, the composition of the IAG, the potential lack of transparency of the IAG as currently constituted and the possible adverse impacts a misguided IAG may have upon the development and enforcement of high quality auditing standards. Such

impacts on auditing standards may negatively influence the efficiency of U.S. capital markets and create negative ripples throughout the economy. Simply put, it seems illogical to establish a non-transparent advisory group to assist in the development of audit requirements to support vibrant and transparent financial reporting.

In creating the IAG, the CCMC believes that it is the intent of the PCAOB to comply with its statutory mission of setting audit standards and assuring that the profession performs high quality audits in conformance with those standards. It is assumed that an advisory group would be used by the PCAOB to enhance its ability to perform its mission by engaging an array of experts, who are stakeholders in financial reporting policy, which represent a wide range of interests. Accordingly, it would be expected that the IAG would meet this intent and that it would operate in an open and transparent manner.

Unfortunately, the CCMC believes that the establishment of the IAG runs counter to this intent, falls outside of the powers of the PCAOB as delineated by the Sarbanes Oxley Act of 2002 ("SOX") and in fact may hamper the PCAOB in performing its core functions.

According to its charter, the IAG is being formed in accordance with the PCAOB's authority under Sections 101 and 103 of SOX. The purported mission of the IAG is to provide a forum in which the PCAOB may obtain the views and advice of experts who have a demonstrated history of commitment to investor protection. In this manner, the IAG is to provide its views and advice to the PCAOB on broad policy issues and other matters that affect investors that may be related to the work of the PCAOB. The IAG charter also states that the PCAOB will look to the IAG to provide high-level advice and insight on matters the PCAOB and staff may face in fulfilling its mission to protect investors under SOX.

The CCMC believes that investor protection is an important aspect of efficient capital markets and appreciates that the PCAOB has latitude in performing its duties and functions under SOX. The CCMC also recognizes that Section 103(a) (4) authorizes the PCAOB and staff to convene such expert advisory groups as may be appropriate. However, Section 103 relates to auditing, quality control, and independence standards and rules, yet the purpose of the IAG is not confined to these matters. While it may include these matters, apparently the IAG has been

formed to provide views and advice to the PCAOB on other, broader issues beyond the purview of Section 103.

If the IAG is being created to advise the PCAOB on issues outside of the domain of Section 103, it begs the question if the IAG is even necessary. The PCAOB is under the supervisory authority of the Securities and Exchange Commission ("SEC"). The SEC has already established an Investors Advisory Committee ("IAC") and one must wonder why a duplicative advisory group is necessary if the supervisory organization of the PCAOB already has a group akin to the IAG. It would seem that the SEC, which is the regulatory body charged with investor protection, would direct the PCAOB to take action to protect investors if it deems necessary in its supervisory role.

Furthermore as noted above, the PCAOB already has a Standing Advisory Group (the "SAG"), which functions consistently within the requirements of Section 103(a) (4). SAG advises the PCAOB on the establishment of auditing and related professional practice standards.[1] Indeed, a number of the members of the inaugural IAG currently serve, or have previously served, on SAG. This raises a related questions on the need for an IAG given the existence of SAG and on IAG's role vis-à-vis SAG.[2] The SAG is made up of many diverse interests that are stakeholders within the scope of audited public company financial reports. By creating a narrowly focused advisory group it seems that potentially duplicative efforts may cause regulatory confusion and potential manipulation that can ultimately harm the audit process. The PCAOB benefits from the SAG because the SAG provides a forum for open debate by its different constituencies who have diverse but equally important stakes in the matters under discussion. Thus the PCAOB benefits from a fair and balanced dialogue. Because the composition of the IAG is not diverse it does not appear to be organized to provide equally balanced recommendations to the PCAOB.

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[1] At the staff level, for more technical advice and discussion, the PCAOB's 2008 Annual Report discloses an Audit Risk Working Group. According to this disclosure, the PCAOB senior staff meets regularly with the lead technical partners of the largest accounting firms and the Center for Audit Quality. The PCAOB's objectives for this Group are to provide an additional venue (outside of the inspection process and other venues such as SAG) and further its efforts to identify, monitor, and assess events affecting audit risk, and gain an improved understanding of risk assessment methodologies employed by the firms.

[2] In addition, although little information seems available on it, we understand that the PCAOB has a Chairman's Advisory Committee and perhaps other advisory groups, too. Such advisory groups likewise seem in conflict with the assumptions we previously outlined and similar concerns exist about the role of IAG vis-à-vis these other advisory groups.

SOX Section 103(a) (4) also states that expert advisory groups may include practicing accountants and other experts, as well as representatives of other interested groups. Yet, in forming the IAG, the PCAOB has chosen to include only representatives from *one* interested group, namely investors and even then it would appear that not all investor groups are represented. By design, the IAG is not comprised of experts, from all groups interested in the mission and activities of the PCAOB, that have a demonstrated history of commitment to investor protection, including practicing accountants, audit committees, and issuers.[3] If the PCAOB has decided to form an advisory group representing a specific group of interests, it would seem to also be in the interest of the PCAOB to establish other advisory groups to represent other interests such as issuers or auditors.

Media reports indicate that the IAG will also advise the PCAOB on the recommendations in the Final Report of the U.S. Department of the Treasury Advisory Committee on the Auditing Profession (the "ACAP") issued October 6, 2008.[4] Such a role reinforces our concerns over the inconsistency of the IAG with the assumptions we previously outlined. Input from all groups is absolutely essential to inform the PCAOB's deliberations, prior to taking any formal actions, on the ACAP recommendations.[5]

The CCMC notes that the IAG charter specifies the terms of members as annual and members may be nominated to serve consecutive terms, such terms being for three years, although no person may serve as a member of the IAG for more than nine consecutive years. Limiting service to consecutive years of nearly a decade is not much of a limitation. Indeed, rather than acting as an advisory board, the IAG

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[3] It is probably worth pointing out that many issuers are likewise investors.

[4] *Compliance Weekend*, September 25, 2009

[5] This point is reinforced by considering the first formal public action, by Board vote, on the ACAP recommendations, which is a *Concept Release on Requiring the Engagement Partner to Sign the Audit Report* (PCAOB Release No. 2009-005), issued for public comment in July 2009. The comment period has closed and the PCAOB received 23 comment letters, only two of which are from investor representatives. Thus, this ACAP recommendation elicited little interest from the investor community. Further, and importantly, the comment letters from audit firms and related organizations provide robust and educational discussions of the nature of the audit process and the potential implications of the proposed requirement for that process and audit quality. Any such discussions, including explanations of how such a requirement risks tearing apart the essential fabric of the audit process, are completely absent from both the ACAP Final Report and the *Concept Release*.

appears to be a special club allowing selected interests to have a permanent seat at the table. Moreover, a number of the inaugural members of IAG have long-standing service on SAG and there is no indication that membership on SAG will be taken into consideration in determining limitations for service on IAG. Not only has the PCAOB passed up an opportunity to embrace input from fresh voices, but the IAG

appears to be a mechanism for institutionalizing the long-term involvement of selected voices, to the exclusion of others, in PCAOB matters. We believe that membership on the SAG and the IAG should be mutually exclusive – one person cannot be members of both groups. Such a long-term institutionalization of special interests could provide the IAG with a veto power over PCAOB actions.

The IAG charter states that the PCAOB will designate one of its members to serve as Chair of IAG. (The Chair will not be considered a member of IAG.) Among the duties of the Chair are preparing meeting agendas, organizing and overseeing meetings, conference calls and related activities, and acting as the general liaison to the PCAOB. The charter specifies that IAG shall hold one or two-day semi-annual meetings and other meetings may be held at the discretion of the Chair. Together these provisions for the selection and duties of the Chair create an absence of any independent functionality for IAG.

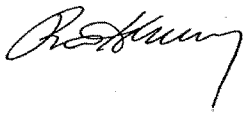
Further, the charter states, at the discretion of the Chair, the IAG's *meetings or portions* thereof *may* be open to the public. There is no commitment in the charter to transparency in the activities of the IAG, such as occurs with open meetings.[6] The CCMC assumes that the PCAOB seeks to conduct its activities consistent with the spirit of the Federal Advisory Committee Act ("FACA"). FACA recognizes the importance of advisory groups and determines parameters so that they function with transparency and in the open. FACA specifically requires open meetings, with very narrow exceptions, and record keeping. Specifically, the SEC's IAC adheres to the sunshine requirements of FACA. While we understand that the legal status of the PCAOB and its ultimate adherence to federal procedural laws will be determined by the United States Supreme Court, the Chamber is deeply concerned by a lack of transparency surrounding the IAG. Advisory groups by nature need to be diverse and

[6] CCMC has previously expressed concerns about the lack of transparency around the PCAOB's standard-setting process. For example, see the April 20, 2009 letter to the PCAOB from the U.S. Chamber of Commerce Center for Capital Markets Competitiveness on the *Proposed Auditing Standard on Engagement Quality Review* (Docket Matter No. 025) that encourages the Board to develop a more transparent and open standard-setting process.

in order to be effective allow for and promote a vigorous debate. This disturbing lack of transparency for selected voices seated at the table on a near permanent basis is at the least troubling and at its worst may allow a regulatory body to be hijacked. The consequences under that scenario could be devastating to our capital markets and future economic growth.

In conclusion, the CCMC believes that the IAG as currently envisioned will lead to misguided input and potentially have severe adverse consequences for the quality of public company audits. These issues in turn could lead to disruptions within the capital markets and cascade through the economy. Accordingly, the CCMC believes that the IAG as currently envisioned needs to be reevaluated in terms of scope, composition, transparency and operations. The CCMC is happy to discuss these concerns in more detail and looks forward to your response.

Sincerely,



Richard Murray
Chairman
Center for Capital Markets Competitiveness
U.S. Chamber of Commerce

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