Testimony of

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on

JOBS Act Implementation

House Committee on Small Business

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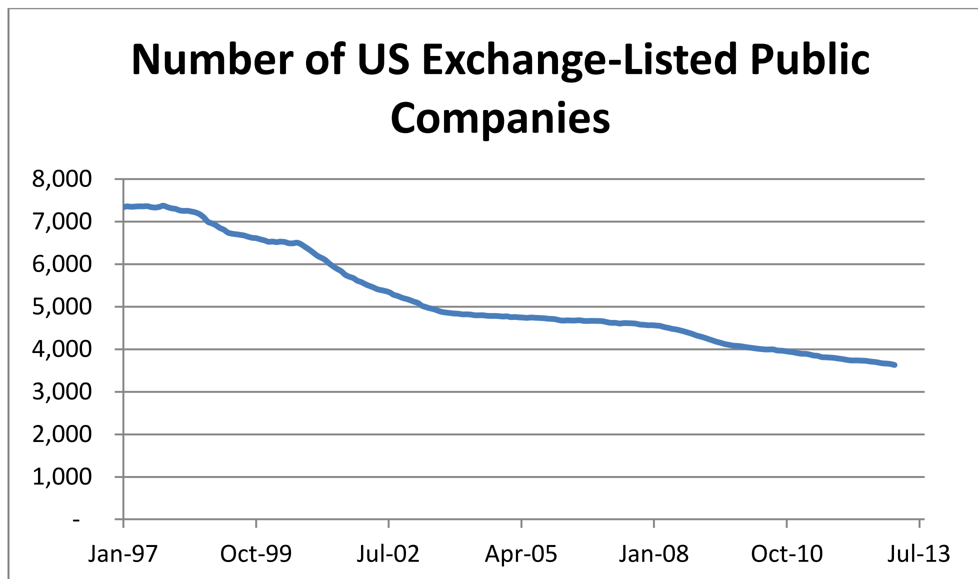
Key points:

- The JOBS Act was passed in response to the twin crises of the Great Recession and the crisis in capital formation in the United States. There are now have approximately half as many U.S. exchange-listed companies as there were 15 years ago.
- Most of the JOBS Act could and should have been done by the SEC under its own volition. Congress should study why the SEC did not act and seek ways of improving the SEC's effectiveness in understanding of the big economic picture and adopting economically sound regulations.
- The SEC has missed numerous Congressional rulemaking deadlines while devoting substantial resources to non-Congressionally mandated rulemaking activities.
- The SEC should adopt temporary interim rules for crowdfunding and analyze the results while it prepares permanent rules, rather than engage in endless contemplation.
- The SEC should permit issuing companies to select their own tick size. Issuers have the incentive to get it right because it is their stock that is affected.
- Many of the features of the JOBS Act make it easier for companies to avoid becoming public companies. The regulatory focus should be on fixing the public markets rather than making it easier to avoid them.
- The SEC needs more resources in order to do its job properly. The SEC's cumulative budget since its founding is less than investors lost from one Bernie Madoff.
- Given the past misallocation of resources, Congress needs to monitor the SEC carefully to make sure that it hires people with the appropriate financial and technical qualifications instead of more inexperienced lawyers.

Introduction: The need for the JOBS Act

My name is James J. Angel and I am an associate professor of finance at the McDonough School of Business of Georgetown University. This year I am a visiting associate professor at the Wharton School of the University of Pennsylvania.[1] I study the operation and regulation of financial markets and have been following the JOBS Act since its inception.

The JOBS Act was enacted in reaction to the twin crises affecting our country – the crisis in capital formation signaled by the continuing decline in the number of exchange-listed US public companies, and the massive unemployment stemming from the Great Recession. The number of U.S. public companies listed on our exchanges has been shrinking steadily for the last 15 years. We have gone from 7,337 U.S. companies traded on our exchanges in January 1997 to only 3,626 at the end of December 2012, a loss of over 50%.[2] We are not creating enough new public companies through initial public offerings (IPOs) to replace those that are lost to attrition.



In short, our public capital markets are no longer nurturing the smaller dynamic companies that represent our economic future. This decline in the U.S. public equity markets represents a crisis in capital

[1] I also serve on the boards of the Direct Edge stock exchanges (EDGX and EDGA). My views are strictly my own and do not necessarily reflect the views of Georgetown University, the University of Pennsylvania, Direct Edge, or anyone else.

[2] These numbers are for U.S. public companies listed on NYSE, NASDAQ, and AMEX, not including foreign ADRs or Exchange Traded Funds (ETFs). Data are from the Center for Research in Securities Prices (CRSP).

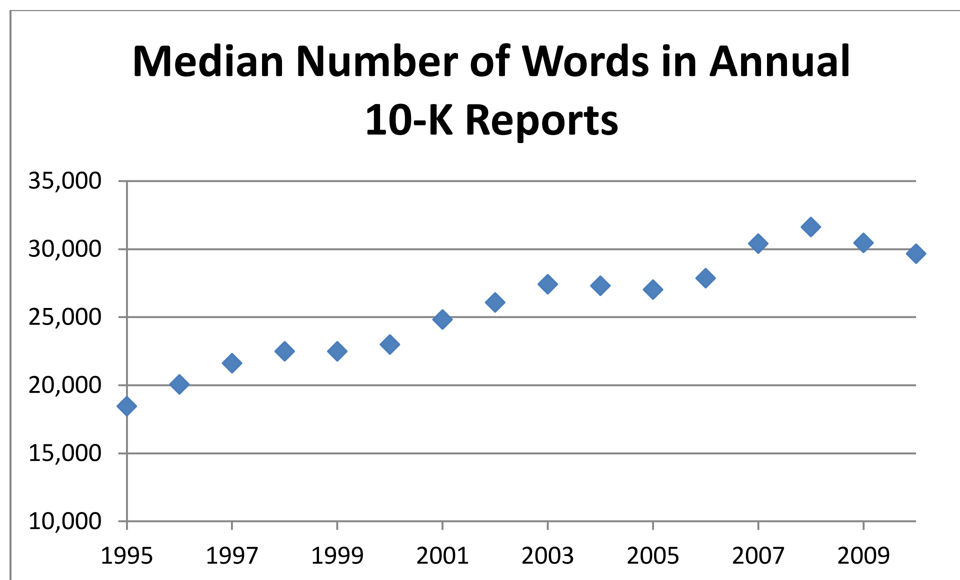
formation. We have made it so difficult and burdensome to be a U.S. public company that fewer companies are going public. By closing off the public markets, we restrict the opportunities for growing companies to raise needed capital for growth and for venture investors to harvest their investments. This means less capital investment, less growth, and fewer jobs.

There are multiple drivers to this trend, and much debate over the causes. A non-exhaustive list includes:

Compliance costs

One of the main drivers of this trend has been the increasing compliance costs that we have placed on U.S. public companies but not on private companies. Regulations continue to require ever more extensive disclosures of public companies but not private ones. For example, recent regulations require companies to provide expensively audited reports on the use of "conflict minerals" from the Democratic Republic of the Congo in their supply chains, even if they purchase no such minerals from the Congo. [3] However, private companies that do business in the dark in the Congo have no such disclosure requirements.

Even before the conflict minerals requirements, the creeping nature of required disclosures has resulted in longer and longer required annual reports on Form 10-K. From 1995 to 2010 the median number of words in a 10-K filing has increased from 18,450 to 29,653, a 61% increase. [4]

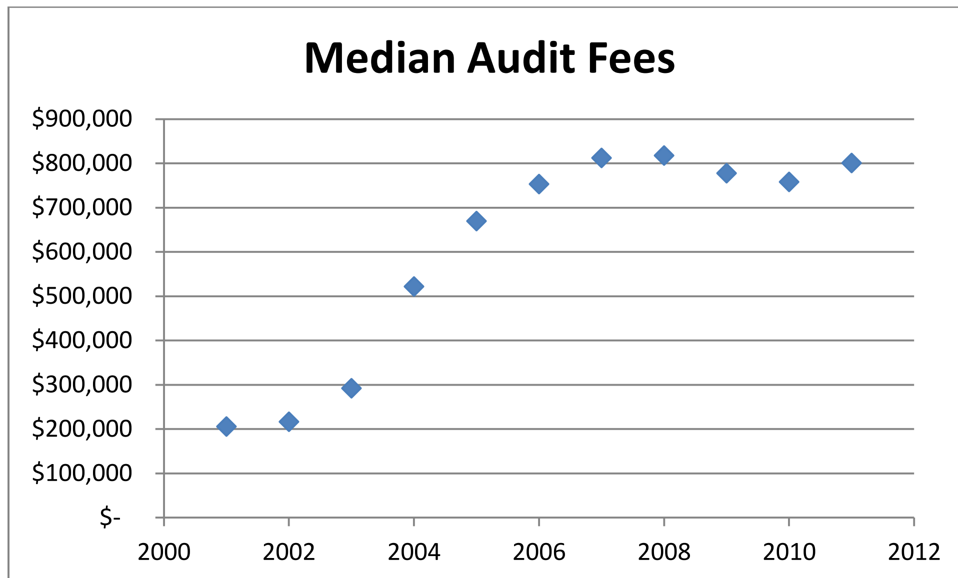


Costs rise commensurately with this increase in disclosures. The following chart demonstrates that the median audit and audit-related fee paid by a U.S. exchange listed company quadrupled from $205,620 in

[3] See the 356 page final rule at http://www.sec.gov/rules/final/2012/34-67716.pdf

[4] This is based on the word count data found on Li Feng's web site, http://webuser.bus.umich.edu/feng/.

2001 to $800,608.[5] A large part of this is the result of Sarbanes-Oxley requirements, which are applied to public but not private companies.



The bottom line is that we have made it so expensive to be a public company that smaller companies can no longer cost-effectively access the public equity markets. Growing companies have no other choice but to go to the private equity market.

Litigation risks

Although all companies in this country are targets for abusive lawsuits, public companies have an extra "sue me" sign painted on their backs. Any bit of bad news affecting a company can lead to a series of "shareholder" lawsuits. This leads to a double penalty for the real shareholders, who suffered from the original bad news as well as the costs of dealing with the litigation. Approximately 6% of exchange-listed firms are sued each year.[6] Over the course of two decades, there are better than even odds that a public company will be the target of such litigation. This added risk is yet another reason for firms not to go public. As one CEO of a private firm explained to me "If I go public, I get sued."

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[5] Data on audit fees obtained from Audit Analytics.

[6] According to the Stanford Securities Class Action Clearing House, there were 152 lawsuits filed in 2012 and comparable amounts in previous years. Dividing the 152 lawsuits by the 3,626 public companies at the end of 2012 gives a hazard rate of 6.37%. http://securities.stanford.edu/ The Clearing House also concluded that previous attempts by Congress to reign in such litigation such as Private Securities Litigation Reform Act of 1995 had little effect. Their web site states "The absolute number of issuers sued does not appear to have changed dramatically since passage of the Act, once the effects of the IPO Allocation Litigation are excluded."

Market structure changes

The United States used to have a very different structure for trading small cap stocks. The old NASDAQ dealer market operated a very different market mechanism from the auction market used on the NYSE and the AMEX. A series of technological, economic, and regulatory changes have led to a U.S. market structure that is the essentially the same for all exchange-listed companies. Many of these changes were well-intentioned and have resulted in a market structure for large-cap companies that works extremely well. However, it is by no means clear that the best market structure for large-cap companies is the same as for small-cap companies.

We should encourage innovation and experimentation in the market structure for smaller companies. We should allow the exchanges to adopt different mechanisms for different types of stocks. However, the SEC staff has been extremely reluctant to let exchanges try anything really different. The result is a "one market fits all" approach that does not fit our small companies well.

The JOBS Act also provided a very important nudge to the SEC to re-examine the issue of the tick size. Section 106 required the SEC staff to study the issue and explicitly authorized the SEC to set different tick sizes for emerging growth companies.[7] The "tick" is the minimum price increment at which stocks trade.[8] For example, our markets will allow an investor to place an order to buy Microsoft at $25.00 or $25.01, but not $25.0001. When our markets switched from trading in fractions to decimals, the tick size fell from 12.5 cents to 1 cent for most stocks. This was enshrined in SEC Rule 612.[9]

This sounds like a narrow technical issue, and it is, but it is one that is very important to the trading of stocks.[10] The optimal tick is not zero, and it is different for different firms, even with the same price level.[11] For example, the Bank of America (BAC) is a $12 bank stock that trades an average of about 150 million shares per day. New Jersey Bancorp (BKJ) is a $12 bank stock that trades an average of less

[7] This authorization to set tick sizes appears to be redundant, as the SEC already sets tick sizes in Rule 612. To the best of my knowledge no one has ever challenged the SEC's authority to set such rules.

[8] I testified on this issue before the House Commerce Committee's Subcommittee on Finance and Hazardous Materials on April 16, 1997. The subject was HR 1053, The Common Cents Stock Pricing Act of 1997.

[9] Rule 612 -- Minimum Pricing Increment, reads

a. *No national securities exchange, national securities association, alternative trading system, vendor, or broker or dealer shall display, rank, or accept from any person a bid or offer, an order, or an indication of interest in any NMS stock priced in an increment smaller than $0.01 if that bid or offer, order, or indication of interest is priced equal to or greater than $1.00 per share.*

[10] For more details, see my comment letter to the SEC on tick size, http://www.sec.gov/comments/jobs-title-i/tick-size-study/tick-size-study-1.pdf.

[11] For a mathematical model of the optimal tick size, see Angel, James J., 1997, Tick Size, Share Prices, and Stock Splits, *Journal of Finance* 52: 655–681.

than 2,000 shares per day. Yet they both have the same tick size of $.01, thanks to the "one-tick-fits-all" approach of SEC Rule 612. Bank of America would probably be better off with a tick size of one half penny, while the trading in New Jersey Bancorp would benefit from a wider tick size.

The SEC staff actually met the deadline for studying the issue.[12] Their study was basically a review of previous literature on tick size changes, and a call for more study. The SEC also held a roundtable on the issue, and is apparently planning a pilot program to examine the impact of different tick sizes.[13] As an academic I love pilot studies, because they give me lots of data to play with.

However, the real public policy question is "Who decides the tick size?" The SEC? The exchanges? The issuers? Given that the optimal tick size is different for different companies, I am of the opinion that the issuers themselves should pick their tick sizes. If the issuers pick the wrong tick size, the liquidity (and thus the share price) of their firms will suffer, so they have the best incentive to get it right. If the tick size is too big, a higher than optimal bid-ask spread will drive up investor's transactions costs and lead to a lower stock price. If the tick size is too small, the stock will suffer from illiquidity and the share price will also suffer. The issuers themselves should have the flexibility to experiment with different tick sizes in order to discover the right tick size.

Collapse of dotcom bubble

Clearly, the dotcom bubble had an impact on our capital markets. However, there were only approximately 500 dotcoms that went public, so the decline in the number of U.S. companies listed on our exchanges is not an artifact of the bubble.

Overall market conditions

Clearly the mediocre performance of the equity markets in recent years has led to a challenging environment. However, there was a recovery in the middle of the last decade before the onset of the Great Recession, and stock prices have since recovered and reached new highs. Although the entire world has experienced similar overall economic conditions, the other countries have not experienced the same precipitous decline in the size of their public equity markets.

The rise of private equity

Some argue that there is less need to go public because of the growth of the private equity industry. However, much of the growth of the private equity has been driven by the closure of the public equity market to smaller issuers. In short, smaller firms have no place else to go, and private equity firms have stepped in to fill the gap – for a price. The closure of the public equity option gives growing companies fewer potential sources of capital.

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[12] http://www.sec.gov/news/studies/2012/decimalization-072012.pdf

[13] http://www.sec.gov/news/press/2013/2013-16.htm

The shutting down of the public equity markets for smaller firms has created lucrative opportunities for the private equity firms that are not available to ordinary investors and the mutual funds we invest in.

The JOBS Act and SEC authority

The JOBS Act makes numerous changes to U.S. regulatory policy. It relaxes disclosure requirements for smaller companies, reduces restrictions on marketing activities in securities offerings, provides a regulatory framework for crowdfunding, and calls for various studies.

Almost all of these provisions are things that the SEC could and should have done on its own. The SEC has abundant legislative authority to set rules and to exempt smaller companies from various rules.[14] The question that Congress should be asking is "Why hasn't the SEC exercised its powers to do this on its own?" What is wrong with the structure, culture, and operation of the SEC that led to this, and what should be done about it?

For example, Congress had to step in to assert that it was legal for emerging growth companies to "test the waters" to see if investors were interested in a public offering before the company went to the expense of filing a formal registration statement with the SEC. In its FAQ on the JOBS Act, the SEC staff points out that accepting nonbinding indications of interest for any firm is not a violation of Rule 15c2-8(e), and that the rule only applies once a registration statement has been filed with the SEC, past regulatory behavior had left the impression that such testing the waters risked unpleasant sanctions from the SEC.[15]

JOBS Act deadlines

The JOBS Act specified that the SEC should adopt rules to facilitate crowdfunding within 270 days of the enactment of the legislation. A year has gone by, and the Commission has not even published proposed rules. What it has done is put out a chilling message saying that crowdfunding is illegal until the SEC decides to make it legal by adopting the rules.

[14] Section 36 of the Securities Exchange Act of 1934 gives the Commission very broad exemptive authority.

[15] http://www.sec.gov/divisions/marketreg/tmjobsact-researchanalystsfaq.htm

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U.S. Securities and Exchange Commission

Information Regarding the Use of the Crowdfunding Exemption in the JOBS Act

On April 5, 2012, the Jumpstart Our Business Startups (JOBS) Act was signed into law. The Act requires the Commission to adopt rules to implement a new exemption that will allow crowdfunding. Until then, we are reminding issuers that any offers or sales of securities purporting to rely on the crowdfunding exemption would be unlawful under the federal securities laws.

http://www.sec.gov/spotlight/jobsact/crowdfundingexemption.htm

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Just a few days ago, on April 9, 2013, more than a year after the passage of the ACT and more than three months after the missed deadline for rules, Crowdcheck held a conference here in DC at which an SEC staffer spoke. At the Q&A part of the presentation, he was asked whether the SEC would have adopted the required regulations by the ***second*** anniversary of the Act, more than 15 months after the deadline. The staffer could not say. **Apparently the regulations are on such a slow track at the Commission that it is questionable whether companies that are starving for capital will be able to access crowdfunding more than 15 months after the Congressional deadline.**

The Commission is also very far behind on many of the rulemakings required under Dodd-Frank. However, the Commission has taken on itself to devote substantial resources to rulemakings in other areas that Congress did not deem important enough to mention in either Dodd-Frank or the JOBS Act. These endeavors include efforts to change the money market fund industry, and its 377 page proposal on Systems Compliance and Integrity.[16]

One reason for the SEC's hesitancy with regard to rule writing has to do with the legal risk that its rules will be overturned due to faulty cost-benefit analysis. The courts have rightly struck down some SEC rules because of faulty cost-benefit analysis. Rather than providing a solid economic justification for its rules, the SEC's cost benefit analyses were a perfunctory afterthought buried near the end of its rule proposals. Although the SEC claims to have learned its lesson and promises to do a better job of economic analysis, it remains to be seen whether a lawyer-run agency like the SEC has really changed.[17] The culture of a large organization like the SEC is very hard to change.

Another possible reason for hesitancy is the fear of making a mistake. With some rules, it is indeed better to take additional time to get them right rather than fast. By spending more time to study and reflect on a rule, it is plausible that a rule will be better for the delay. However, with an economy facing massive unemployment, such a leisurely approach is not appropriate as delay is costing jobs. Congress

[16] http://www.sec.gov/rules/proposed/2013/34-69077.pdf

[17] http://www.sec.gov/news/testimony/2012/ts041712mls.htm

appropriately gave the SEC a 270 day deadline for adopting crowdfunding rules which the agency has inappropriately ignored.

It is clear that the SEC did not take extra time because it was intently studying the issue. It took the extra time because it was **not** studying the issue. For example, on July 26, 2012, a conference was held on crowdfunding at the Georgetown University Law Center in order to discuss crowdfunding and the JOBS Act.[18] This event was within walking distance of the SEC headquarters. A number of noted academics and practitioners were there, and the SEC was invited. Yet nobody from the SEC thought the topic was important enough to show up. (One staffer did show up in the afternoon after I contacted one of the Commissioner's offices and pointed out how embarrassing it was to the Commission that nobody from the Commission was in attendance.) This pattern of ignoring the intellectual contributions happening outside the Commission is one of the reasons that the Commissions economic understanding of markets has suffered.

However, the delay in adopting the required crowdfunding rules stems from more than just the fear that the rules will be overturned. The Commission has shown a pattern of antipathy towards the idea of crowdfunding from the beginning and is in great danger of killing the idea through regulatory delay and overregulation.

The concept behind "crowdfunding" is quite simple: Let small companies raise small amounts of capital with a minimum of expensive regulatory requirements. Limiting the amount that any one investor can invest to a modest amount limits the risk to that investor. The SEC basically ignored a rulemaking petition in 2010 to permit small offerings of up to $100,000 with a maximum of $100 per investor[19]. The SEC received over 100 comments supporting the petition. [20]

To be sure, there are some serious issues with respect to crowdfunding. The first is investor protection from fraud and abuse. Hucksters could raise funds for dubious enterprises and then just disappear. However, such frauds would still be criminal violations. The second concern is that of disclosure, both at the initial offering and afterwards. Will investors have sufficient information to decide whether to invest in such offerings, either in the primary or the secondary markets? The third issue is the quality of trading in the secondary market. Will investors in such tiny offerings have the ability to sell at a fair price when they need to sell? Will the secondary market be rife with manipulation?

These are indeed legitimate concerns. However, fear of every conceivable bad thing that could happen should not stand in the way of proper experimentation to find out what actually will happen. Limiting the maximum investment to a modest amount limits the risk to any one investor.

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[18] The report can be found at http://www.milkeninstitute.org/pdf/crowdfunding120827.pdf. This is an unfortunate pattern for the SEC. It rarely sends staff people even to local industry conferences that examine important topics on the regulatory agenda. This reflects a false view that there is nothing for the SEC to learn from such events.

[19] http://www.sec.gov/rules/petitions/2010/petn4-605.pdf

[20] http://www.sec.gov/comments/4-605/4-605.shtml. I also submitted a supporting comment letter which can be seen at http://www.sec.gov/comments/4-605/4605-33.pdf.

As far as disclosure goes, as long as investors know that they will get less detailed information than they get from larger offerings, and that these are very high risk investments in which they could and often would lose their entire investment, then they should have the freedom to make such a risky investment. The required disclosure to investors should include a short warning indicating that it is a tiny offering and the investor could lose all their money. This can be done with a very simple and inexpensive "black box" warning label:

For example, it could say:

- **This is a risky investment. You may lose your entire investment!**
- There may not be any market for selling these securities when you want to sell.
- Financial information about this investment may not be as reliable as the audited financial statements of large public companies.

Indeed, such a simple warning label may be far more effective than a two hundred page registration statement that lulls an unsophisticated reader into thinking that the offering is a sound investment that has been thoroughly vetted by the experts at the SEC.

However, the SEC ignored this reasonable petition on crowdfunding, so Congress stepped in with Title III of the JOBS Act. Title III basically provides a regulatory framework for crowdfunding deals up to $1 million dollars with investments as large as $10,000 each, provided they are done through regulated crowdfunding portals. Many other restrictions and requirements are also included.

Many of these regulations sound innocuous, but could in the hands of hostile regulators become a heavy millstone that seriously inhibits the use of crowdfunding. For example, Section 4A(b)(4) requires issuer to

> "not less than annually, file with the Commission and provide to investors reports of the results of operations and financial statements of the issuer, as the Commission shall, by rule, determine appropriate, subject to such exceptions and termination dates as the Commission may establish, by rule; and
> ''(5) comply with such other requirements as the Commission may, by rule, prescribe, for the protection of investors and in the public interest."

In other words, the SEC could easily require full-blown financial reports just like it requires from IBM. There is a temptation for this agency which has been so unresponsive to the will of Congress to over regulate crowdfunding to death in the name of consumer protection.

The concern about the quality of trading should also not prevent innovation and experimentation to proceed. Crowdfunding will probably be most useful in providing seed capital (so-called "angel

financing") for startup ventures. For example, an entrepreneur with a cool idea needs some money to live on so she or he can quit their day job and devote fulltime to launching the venture. The seed money will be spent developing the business plan and proof of concept. Such ventures will usually need additional rounds of capital in order grow. These additional funding rounds will often dilute the original investors, but may also offer exit opportunities. The exit for most of the crowdfunding investors will not be to sell shares into a tiny and totally illiquid secondary market, but to exit when the firm gets another round of financing or when the firm gets acquired.

Crowdfunding is new, and it is unlikely that the adopted rules will be perfect no matter how much time the SEC spends on the rules. **A more common sense approach in the midst of a recession is for the SEC to quickly adopt interim rules.** This will allow the Commission to learn from experience how the rules work and will lead to more informed final rules. One very well done precedent was the SEC's implementation of Rule 204T during the heat of the financial crisis in September 2008. The rule promptly reduced the endemic settlement failures that were an embarrassment to the U.S. equity market. Later, after observing the success of the rule, it was made permanent.[21]

We should fix our public capital markets rather than make it easier to leave them.

The Act increases the threshold to require firms to register with the SEC from 500 shareholders of record to 2000 shareholders of record. Note that this is shareholders *of record*, and not total beneficial shareholders. Since many if not most shareholders hold their shares in street name through a broker or a custodian bank, the number of shareholders of record is much smaller than the number of people who actually own shares. For example, suppose 500 different people own shares that are held in one particular brokerage firm and that brokerage firm is a participant of Depository Trust and Clearing Corporation, the entity that clears and settles most stock transactions in the United States. Then that brokerage firm would appear as the owner of the shares and count as one shareholder of record.

This provision is a two edge sword. Rather than deal with the problems in our public capital markets, Congress made it easier for firms to avoid the public capital markets.[22] It recognizes how burdensome SEC registration has become, and it frees thousands of firms from the requirement of SEC registration. Such firms still need to be SEC registrants in order to be listed on our exchanges, but their shares can still trade in the over-the-counter markets in the U.S. without registration. However, I think that the solution is not to make it easier to leave the public markets, but to fix the public markets so they are more attractive.

[21]. Rule 204T and later Rule 204 basically require firms to deliver sold shares on the regular settlement date and provides for mandatory buy-ins. Alas, the Commission had received thousands of complaints in the previous decade about settlement failures, and tinkered around with a complicated Regulation SHO Threshold list approach to the problem. It took a financial meltdown for the Commission to do the obvious and simple thing – require sellers to deliver the stock on the settlement day – with a temporary rule.

[22] Indeed, a quick search of the Compustat database finds less than 1,400 US exchange-listed firms reporting more than 2,000 shareholders in the database.

The SEC needs the resources to do the job right.

Defenders of the SEC can point out that the SEC has continually suffered from insufficient resources to do its job well. The technical experts who truly understand financial markets and technology are not cheap, and the SEC has not had the resources to attract and retain enough of the highly skilled people it needs to do its job well. Don't get me wrong: There are a lot of intelligent, highly skilled, and dedicated people at the SEC. There just aren't enough of them.

There is one statistic that shows how penny-wise and pound foolish the U.S. has been with its funding of the SEC. From its founding in 1934 to the present time, the cumulative budget of the SEC expressed in current dollars has been about $20 billion. That is less than investors lost from one Bernie Madoff or one Enron.

However, the SEC has a long history of misallocating the resources that it has received. Rather than hiring experienced people with the financial and technical experience it needs to regulate today's complex high-tech markets, it has hired lots of attorneys who engage in hairsplitting minutia while missing the big picture. Don't get me wrong. My father and grandfather were attorneys. I actually like lawyers. They are interesting people and it is fun to get into intellectual debates with them. However, if you have a leaky pipe, you need a plumber, not a lawyer. The SEC needs to hire more market plumbers and fewer lawyers.

Summary and conclusions

In the JOBS Act, Congress told the SEC to be serious about promoting capital formation. Decades of well-meaning changes in our capital markets have created a market structure suited to large companies but not smaller companies.

The SEC has been slow to implement important provisions of the JOBS Act. This is partly due to insufficient resources, both monetary and technical, as well as to foot dragging by the Commission.

What can Congress do?

1. Continue to hold hearings like this to let them know that Congress is watching. Grill the Commissioners and staffers on their performance, and why the Commission has devoted huge amounts of staff time to dealing with less urgent matters that were not on the to-do list that Congress gave them.
2. Write letters to the agency. That gets their attention.
3. Give the SEC sufficient resources to do its job well. The SEC is self-funded through user fees, so this is not a costly to the general fund.
4. Grill the SEC regularly on the makeup of its work force. In addition to the number of lawyers and paralegals on staff, ask them regularly how many SEC staffers have other relevant

qualifications in the financial area(CFA, MBA, Ph.D., Series 7 license, etc.) and in the technical areas (degrees in engineering or IT).

5. Pay attention to the culture of the Commission, and in particular its attitude toward timely and sensible action.
6. Move the SEC to New York and Chicago. In those locations it will be able to draw on a labor pool of people who really understand financial markets. In today's economy, there are plenty of unemployed people with serious financial experience. They know where the bones are buried in our financial markets. The problem is those people are in New York and Chicago, not Washington DC. Locating the SEC in the heart of our financial markets will make it much easier for our regulators to do their job well.