UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

April 6, 2011

The Honorable Darrell E. Issa
Chairman
Committee on Oversight and Government Reform
United States House of Representatives
2157 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Issa:

This responds to your letter of March 22, 2011 concerning capital formation. As you know, facilitating capital formation, along with protecting investors and maintaining fair and orderly markets, is the mission of the Securities and Exchange Commission.

Cost-effective access to capital for companies of all sizes plays a critical role in our national economy. Regardless of the form or size of the offering, companies seeking access to capital in the U.S. markets should not be overburdened by unnecessary or superfluous regulations. At the same time, all offerings must, of course, provide the necessary information and protections to give investors the confidence they need to invest in our markets. Striking the right balance between facilitating access to capital by companies and protecting investors in our rules and orders is a critical goal of the SEC.

Our requirements need to be periodically reviewed to ensure that they are up-to-date and costs and benefits remain appropriately calibrated. For example, as described in more detail below, at my request the staff is taking a fresh look at our rules to develop ideas for the Commission about ways to reduce the regulatory burdens on small business capital formation in a manner consistent with investor protection. In this review, we will seek input from many sources, including a new Advisory Committee on Small and Emerging Companies that the Commission is in the process of forming.

Your letter sets out a series of questions on a variety of capital formation-related topics. In an effort to respond to your inquiries in an organized fashion, I have grouped my responses in the following categories: communications in connection with securities offerings, capital formation and regulatory environment, initial public offerings, triggers for public reporting, new capital raising strategies, investments in start-ups, and future steps.

In addition, you also seek certain studies authored or co-authored by current or former staff of the Commission's Office of Economic Analysis ("OEA"), now the Commission's Division of Risk, Strategy and Financial Innovation ("Risk Fin"), concerning registered and unregistered equity capital formation. Attached as Appendix A is a list of studies responsive to this request. I also am enclosing a disc Bates-numbered SEC_RF_OGR_000001 through SEC_RF_OGR_000452 that contains the listed studies. Beyond these studies, the staff has identified an additional study that appears responsive to your request, but which also appears to contain non-public information. For that study, we will seek to provide it to you after receiving the approval of the Commission.

Communications in Connection with Securities Offerings

Regulation of communications in connection with offerings, whether public or private, begins with the Securities Act of 1933 ("Securities Act"). The Securities Act provides that each offering of securities must be registered with the Commission unless an exemption from registration is available. The degree and means by which an issuer may communicate publicly during the offering process depend on whether the offering is registered under Section 5 of the Securities Act or exempt from registration and, if exempt, the conditions of the particular exemption on which the issuer is relying.

Registered Offerings

Under the Securities Act, for registered offerings, an issuer's ability to communicate publicly varies as it proceeds through the registration process, which has three phases:

- the period prior to the filing of a Securities Act registration statement ("pre-filing period");[1]
- the period between the filing of the Securities Act registration statement and the effectiveness of that registration statement ("waiting period" or "quiet period"); and
- the period after the effectiveness of the Securities Act registration statement ("post-effective period").

During the pre-filing period, an issuer may not "offer" securities.[2] The term "offer" is broadly-defined under the Securities Act[3] and has been interpreted as going well beyond the

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[1] The Securities Act does not state when the pre-filing period begins. The Commission has stated that an issuer will be in registration at least from the time it begins preparing the related registration statement or the time it has reached an understanding with an underwriter, even if all the terms or conditions of the underwriting arrangement have not been agreed upon. *See* Release No. 33-5009, *Publication of Information Prior to or After the Filing and Effective Date of a Registration Statement Under the Securities Act of 1933* (October 7, 1969); Release No. 33-5180, *Guidelines for Release of Information by Issuers Whose Securities Are in Registration* (August 16, 1971).

[2] *See* Securities Act § 5(c).

[3] *See* Securities Act § 2(a)(3) ("The term 'offer to sell', 'offer for sale', or 'offer' shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."). *See also* Release No. 33-3844, *Publication of Information Prior to or After the Effective Date of a Registration Statement* (October 8, 1957); Release No. 33-4697, *Offers and Sales of Securities by Underwriters and Dealers* (May 28, 1964); Release No. 33-5009, *Publication of Information Prior to or After the Filing and Effective Date of a*

common law concept of "offer."[4] During the quiet period, an issuer can make oral offers but cannot make written offers other than through the use of a prospectus that complies with Securities Act Section 10.[5] The prospectus includes comprehensive, balanced information about the issuer and the offering which facilitates investment decisions. As the term "offer" has been broadly construed, in the absence of rules exempting particular communications, issuers should limit communications before and during offerings to avoid being deemed to make illegal offers. Failure to comply with these requirements is sometimes referred to as "gun-jumping."

Once in the post-effective period, an issuer can sell and deliver securities as long as a final prospectus that complies with Securities Act Section 10(a) accompanies or precedes the delivery of the securities.[6] Issuers also can send written offers, such as supplemental sales literature, if they are accompanied or preceded by a Section 10(a) prospectus.

Over the years, the Commission has taken steps to facilitate continued communications around public offerings. For example, as early as 1970, the Commission adopted safe-harbor exemptions to make it clear that continued analyst research coverage does not constitute an unlawful offer.[7]

In one of the most important reforms of the registration and offering process, the Commission in 2005 adopted a comprehensive set of new rules and amendments to facilitate capital formation and relax restrictions on communications by issuers during the registered offering process.[8] These changes significantly liberalized an issuer's ability to communicate publicly during offerings, thereby allowing more information to reach investors. These liberalizations included:

- *Pre-Filing Communications.* To avoid unnecessary limitations on communications by issuers prior to registered offerings, the Commission adopted Securities Act Rule 163A to provide eligible issuers with a bright-line safe harbor for communications made more

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Registration Statement Under the Securities Act of 1933 (October 7, 1969); Release No. 33-5180, *Guidelines for Release of Information by Issuers Whose Securities Are in Registration* (August 16, 1971).

[4] *See, e.g., Diskin v. Lomasney & Co.*, 452 F.2d 871 (2d. Cir. 1971); *SEC v. Cavanagh*, 1 F. Supp. 2d 337 (S.D.N.Y. 1998).

[5] *See* Securities Act § 5(b)(1).

[6] *See* Securities Act § 5(b)(2).

[7] *See* Release No. 33-5101, *Adoption of Rules Relating to Publication of Information and Delivery of Prospectus by Broker-Dealers Prior to or After the Filing of a Registration Statement Under the Securities Act of 1933* (November 19, 1970).

[8] *See* Release No. 33-8591, *Securities Offering Reform* (July 19, 2005), http://www.sec.gov/rules/final/33-8591.pdf.

than 30 days before the filing of a registration statement, thereby reducing the risk of these communications violating the gun-jumping provisions of the Securities Act.

- *Ordinary Course Business Communications.* The Commission adopted two new rules to provide issuers, including non-reporting companies, with greater certainty that their continuing communications of factual business information will not run afoul of the gun-jumping provisions of the Securities Act.[9]

- *Free Writing Prospectuses.* The Commission adopted new rules to permit written offers outside the statutory prospectus[10] – such as e-mails, faxes and pre-recorded electronic communications, called "free writing prospectuses"[11] – to be made to offer securities in certain circumstances.[12]

- *Media Communications and Publications.* Recognizing that the media can be a valuable source of information about issuers and to encourage the role of the media as a communicator of information, the Commission determined that when an issuer or offering participant provides information to the media about the issuer or the registered offering that ordinarily would be viewed as an "offer," the media publication is generally treated as a free writing prospectus of the issuer or offering participant in question (provided the media publication is unpaid and unaffiliated with the issuer).[13]

- *Relaxation of Restrictions on Written Offering-Related Communications.* The Commission expanded the scope of the existing safe harbors of Securities Act Rules 134 and 135 to allow issuers to communicate more details about contemplated offerings without those communications being deemed to be "prospectuses" or "offers," respectively.

- *Research Reports Safe Harbors.* The Commission adopted rule amendments that expanded the scope of the safe harbors for the use of research reports during registered

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[9] *See* Securities Act Rules 168 and 169. Rule 168 provides eligible reporting issuers with the ability to communicate not only factual business information but also forward-looking information that is regularly released in the ordinary course of business. Rule 169 allows all eligible issuers, including non-reporting companies, to continue to communicate factual business information that they regularly release in the ordinary course of their business without such information being viewed as an impermissible "offer."

[10] Prior to the adoption of the new rules, issuers were able to make written offers after the filing of a registration statement only in the form of a statutory prospectus.

[11] *See* Securities Act Rule 405.

[12] *See* Securities Act Rules 163, 164, and 433.

[13] *See* Securities Act Rules 164 and 433(f).

offerings.[14] The amendments were designed to encourage the publication of research reports, which provide the market and investors with valuable information about issuers.

- *Relaxation on Restrictions on Offers for Well-Known Seasoned Issuers.* The Commission adopted Rule 163 to enable the largest of the reporting issuers ("well-known seasoned issuers," or "WKSIs"), which are likely to have the highest degree of market following, to make offers of securities before the filing of the related registration statements.[15]

In your letter, you referenced the initial public offerings of Google, Inc. and The Go Daddy Group, Inc. in connection with the quiet period rules as they relate to initial public offerings, indicating that the quiet period rules delayed the initial public offering of Google and may have resulted in Go Daddy canceling its planned initial public offering.

In April 2004, less than a week before Google initially filed its registration statement for its initial public offering, Google's two founders were interviewed by *Playboy* magazine. Google informed the staff of the interview in August 2004 and advised the staff that the interview would appear in the September 2004 issue of *Playboy*, which was scheduled to hit newsstands after the offering period for Google's innovative "Dutch auction"[16] initial public offering closed. Under the rules in effect at the time of this offering, the publication of an article such as this in connection with an initial public offering could raise concerns about inappropriate market conditioning and the potential need for a cooling-off period. For a variety of reasons, primarily based on (1) the timing of the release of the article after the completion of the offering period for the auction; and (2) Google filing the article as an exhibit to its registration statement (thereby including it as part of its offering materials), the staff determined that the publication of the article would not inappropriately condition the market for Google's initial public offering. As such, the staff did not impose any cooling-off period or otherwise delay the offering as a result of the article. Beyond this, it is important to note that, had the 2005 communications rules described above been in effect at the time, even if the *Playboy* article was published before Google's offering period for the auction had closed, Google's initial public offering would not have been delayed.

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[14] *See* Securities Act Rules 137, 138, and 139.

[15] *See* Securities Act Rule 163.

[16] A "Dutch auction" initial public offering differs from the "bookbuilding" manner in which initial public offerings typically are made in the United States. In a bookbuilding initial public offering, underwriters gather and assess potential investor demand for a securities offering and seek information important to their determination as to the size and pricing of an issue through soliciting investor interest within a price range. Prospective investors are permitted to revise bids before the bookbuilding closes. In a Dutch auction, the method of pricing an initial public offering is determined by investors expressing their interest level and price threshold, and the offering price is set at the highest level at which all of the shares to be offered can be sold. The Commission took steps to ensure that its rules accommodated the Dutch auction process.

By contrast, another initial public offering in 2004 had a different result under the rules in existence at the time. Salesforce.com, Inc. had planned to go effective on its registration statement in May 2004 when an article appeared in *The New York Times* featuring an interview with the company's CEO.[17] The CEO had invited a reporter to follow him for a day during the road show for the offering, and the article, which was published during the road show, included substantial information about the offering. It appeared to the staff that the interview was granted – and the reporter was given access to the road show process – in an effort for Salesforce.com or its CEO to communicate with prospective investors through the article, which was not permitted under the rules at that time. To address gun-jumping concerns, the staff imposed a cooling-off period. Under the communications rules adopted in 2005, this media coverage would not have required delay of the offering if certain filings, such as filing a copy of the article or its contents as a free-writing prospectus, were made.

Go Daddy filed its registration statement for its initial public offering on May 12, 2006 and withdrew it less than three months later on August 8, 2006. The request for withdrawal cited "unfavorable market conditions" as the reason for the termination of the offering. Although the staff does not have additional first-hand information as to the reasons for the Go Daddy decision to cancel its planned initial public offering, a posting on the blog of Bob Parsons, the chief executive officer of Go Daddy, cited a number of reasons, including the quiet period rules, for the decision.[18] Mr. Parsons' objections to the quiet period rules appear to have rested, at least in part, on his understanding that the rules imposed restrictions on his ability to conduct his weekly radio show.[19] In point of fact, our communication restriction rules would not have prevented Mr. Parsons from conducting his show, but would have prevented him from using the radio show to promote the offering. In liberalizing the communications rules in 2005, the Commission determined that, in the case of initial public offerings, investors should be provided a prospectus before issuers are permitted to market an offering through radio or television in order to assure a balanced presentation.

Offerings Not Registered Under the Securities Act

In offerings that are exempt from registration under Section 5, the extent to which an issuer may communicate publicly depends on the requirements of the exemption upon which the issuer is relying. One of the most commonly-used exemptions is Section 4(2) of the Securities Act, which exempts transactions by an issuer "not involving any public offering." Currently, an

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[17] Gary Rivlin, *It's Not Google. It's That Other Big I.P.O.*, The New York Times, May 9, 2004.

[18] *See* Bob Parsons, *Go Daddy Pulls Its IPO Filing! Why I Decided to Pull It*, Bob Parsons' Personal Blog (August 8, 2006), http://www.bobparsons.me/121/godaddy-pulls-ipo-filing-why-decided-pull.html. *See also* Matt Krantz, *IPO Indigestion Grows as Go Daddy Balks*, USAToday.com (August 10, 2006), http://www.usatoday.com/money/markets/us/2006-08-09-ipo-usat_x.htm; Jonathan Berr, *Go Daddy Yanks IPO*, The Street (August 9, 2006), http://www.thestreet.com/story/10302695/go-daddy-yanks-ipo.html.

[19] *See* Parsons, *supra* note 18.

issuer wishing to rely on Section 4(2) or its safe harbor – Rule 506 of Regulation D – is generally subject to a ban on the use of general solicitation or advertising to attract investors for its offering.[20] The ban was designed to ensure that those who would benefit from the safeguards of registration are not solicited in connection with a private offering.

The Commission and staff have acted to facilitate capital raising in private offerings by adopting safe harbor rules – such as Rule 506 – and providing guidance with respect to the scope of Section 4(2) and the ban on general solicitation and advertising.

For example, in 2001, the Commission adopted Rule 155, a safe harbor under the Securities Act, to address concerns about a company's ability to abandon a public offering and, instead, raise money in a private offering. Without this safe harbor, the publicity from the public offering could be viewed as inconsistent with a private offering. Under the safe harbor, an issuer that filed a registration statement for a public offering but then determined not to proceed with the public offering can abandon the registration statement and proceed with a private financing provided certain conditions are satisfied.[21] Rule 155 also permits private offerings in certain circumstances to be abandoned and converted into public offerings.[22] Most recently, in 2007, the Commission clarified that filing a registration statement for an offering would not automatically be viewed as a general solicitation for a concurrent private offering. Instead, the analysis should focus on whether the private offering investors were actually solicited through the registration statement.[23] Finally, through its no-action letters, the staff has provided flexibility for the use of

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[20] *See* Rule 502(c) of Regulation D ("Except as provided in Rule 504(b)(1), neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising…"); Release No. 4552, *Non-Public Offering Exemption*, (November 6, 1962) ("Negotiations or conversations with or general solicitations of an unrestricted and unrelated group of prospective purchasers for the purpose of ascertaining who would be willing to accept an offer of securities is inconsistent with a claim that the transaction does not involve a public offering even though ultimately there may only be a few knowledgeable purchasers.").

[21] Release No. 33-7943, *Integration of Abandoned Offerings* (January 26, 2001), http://www.sec.gov/rules/final/33-7943.htm. The conditions include that (a) no securities were sold in the registered offering; (b) the registration statement is withdrawn; (c) the private offering commences at least 30 days after the registration statement is withdrawn; and (d) certain disclosures are made to the purchasers in the private offering.

[22] The conditions required to convert abandoned private offerings into public offerings include that (a) no securities were sold in the private offering; (b) all private offering activities cease before the registration statement is filed; (c) unless the private offering was made to only accredited or sophisticated investors, at least 30 days has passed since the cessation of offering activity in the private offering before the registration statement is filed; and (d) certain disclosures are made in the registration statement used in the public offering.
In addition, the Commission adopted Securities Act Rule 135c, a safe harbor allowing reporting issuers to notify the public of their planned exempt offerings. Rule 135c allows issuers to disclose basic information about themselves and their offerings, so long as the conditions of the rule are satisfied. *See* Release No. 33-7053, *Simplification of Registration and Reporting Requirements for Foreign Companies; Safe Harbors for Public Announcements of Unregistered Offerings and Broker-Dealer Research Reports* (April 19, 1994).

[23] *See* Release No. 33-8828, *Revisions of Limited Offering Exemptions in Regulation D* (August 3, 2007), http://www.sec.gov/rules/proposed/2007/33-8828.pdf.

Internet and other modern communication technologies in private offerings without running afoul of the general solicitation ban.[24]

Early this year, it was reported that Facebook and Goldman Sachs & Co. were planning to offer up to $1.5 billion of securities of Facebook to clients of Goldman Sachs residing both inside and outside the United States. Goldman Sachs intended to conduct the offering in the United States as a private placement in reliance on Section 4(2). The transaction received intense media coverage and public interest and, on January 17, 2011, Goldman Sachs announced that it was limiting the offering to investors outside the United States. Goldman Sachs said it "concluded that the level of media attention might not be consistent with the proper completion of a U.S. private placement under U.S. law." At no point in time did the staff advise or instruct Facebook or Goldman Sachs that the offering could not be conducted in the United States. Moreover, as noted above, in 2007 the Commission indicated that the proper analysis of whether a general solicitation occurred focused on whether the investors participating in the offering were actually solicited through the activities which could be viewed as a general solicitation or if, for example, the investors were existing clients or those with whom a pre-existing relationship existed.

I recognize that some continue to identify the general solicitation ban as a significant impediment to capital raising.[25] I also understand that some believe that the ban may be unnecessary because offerees who might be located through the general solicitation but who do not purchase the security, either because they do not qualify under the terms of the exemption or because they choose not to purchase, would not be harmed by the solicitation.[26] At the same time, the general solicitation ban has been supported by others on the grounds that it helps prevent securities fraud by, for example, making it more difficult for fraudsters to attract

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[24] *See, e.g.*, IPONET (July 26, 1996) (general solicitation is not present when previously unknown investors are invited to complete a web-based generic questionnaire and are provided access to private offerings via a password-protected website only if a broker-dealer makes a determination that the investor is accredited under Regulation D); Lamp Technologies, Inc. (May 29, 1998) (posting of information on a password-protected website about offerings by private investment pools, when access to the website is restricted to accredited investors, would not involve general solicitation or general advertising under Regulation D).

[25] *See, e.g.*, *Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission* (April 23, 2006), http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf; Joseph McLaughlin, *How the SEC Stifles Investment – and Speech*, The Wall Street Journal (February 3, 2011). Concerns about the scope of the Commission's rules on general solicitation and advertising have been raised by the participants in the annual SEC Government-Business Forum on Small Business Capital Formation. *See 2009 Annual SEC Government-Business Forum on Small Business Capital Formation Final Report* (May 2010), http://www.sec.gov/info/smallbus/gbfor28.pdf.

[26] *See Pinter v. Dahl*, 486 U.S. 622, 644 (1988) ("The purchase requirement clearly confines §12 liability to those situations in which a sale has taken place. Thus, a prospective buyer has no recourse against a person who touts unregistered securities to him if he does not purchase the securities.").

investors or unscrupulous issuers to condition the market.[27]

Neither the Commission nor the staff has had occasion to consider the constitutionality of the quiet period rules under the First Amendment. I understand that First Amendment issues have been raised in the context of private offerings, however, in connection with at least one no-action letter request. That request is still pending.

With respect to your question regarding a cost benefit analysis of the quiet period rules, as the Supreme Court recognized in *Lorillard Tobacco Co. v. Reilly*, "[t]he degree to which speech is suppressed – or alternative avenues for speech remain available – under a particular regulatory scheme tends to be case specific."[28] Thus, the First Amendment implications of the quiet period rules, or any other regulations, are typically best considered in context. For example, no-action or exemptive requests allow consideration both of the precise regulation at issue and the circumstances of the particular offering, and also allow the staff or the Commission to tailor a response to accommodate the interests at stake. Additionally, specific rulemakings would allow a more concrete context in which to consider the interests at issue.

Capital Formation and Regulatory Environment

Over the years, the Commission has taken a number of actions to facilitate capital raising by companies of all sizes and to reduce burdens on companies when making securities offerings. From the introduction of shelf registration of delayed and continuous offerings in the 1980's, to the reduction of the eligibility threshold for shelf registration in the early 1990's, to modernizing communications and the offering process in 2005, the Commission has regularly considered and implemented changes to its rules to reduce regulatory burdens on the offering process while maintaining necessary investor protections provided under the Securities Act. The Commission also has undertaken efforts specifically designed to facilitate capital formation by smaller companies by simplifying the regulatory environment for them. Most recently, the Commission adopted a variety of rules facilitating capital raising for small business in public and private offerings. These rules adopted by the Commission:

- simplified the disclosure and reporting requirements for smaller companies and expanded the ability to use less burdensome, scaled disclosure to more companies;[29]

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[27] *See, e.g.,* J. William Hicks, Exempted Transactions Under the Securities Act of 1933 § 7:160 (2d ed. 2002); Comment Letter from Investment Companies Institute to SEC (October 9, 2007), http://www.sec.gov/comments/s7-18-07/s71807-37.pdf (warning that unlimited general solicitation would "make it difficult for investors to distinguish between advertisements for legitimate offerings and advertisements for fraudulent schemes").

[28] 533 U.S. 525, 563 (2001).

[29] *See* Release No. 33-8876, *Smaller Reporting Company Regulatory Relief and Simplification* (December 19, 2007), http://www.sec.gov/rules/final/2007/33-8876.pdf.

- liberalized the eligibility requirements for certain short-form registration statements and, as a consequence, shelf registration, to allow eligible smaller public companies to benefit from the greater flexibility and efficiency in accessing the public securities markets;[30]

- adopted a rule specifying that employee stock options generally are not required to be considered a class of equity securities for purposes of triggering the registration requirements under Section 12(g) of the Exchange Act,[31] thereby providing certainty to private companies that granting options to more than 500 employees under their employee stock option plans will not require them to become reporting companies;

- implemented electronic filing of the information required by Form D, making it possible, once the states complete implementation of their electronic filing system, for companies to enjoy the benefits of "one stop" filing in private and other exempt offerings; [32]

- amended Rule 144 – the rule that, among other things, provides a Securities Act safe harbor for resales of privately placed securities – to shorten the holding period and provide other regulatory simplifications.[33]

In addition, the Commission has been mindful of the impact of its rules on small business in connection with its other rulemaking activity. For example, in connection with adopting rule amendments implementing the "say-on-pay" provisions of the Dodd-Frank Act, the Commission provided a two-year phase-in period for smaller reporting companies.[34] This phase-in is a balanced way for the Commission to determine whether its rules would disproportionately burden smaller reporting companies and make any needed changes before the rules become applicable to them. The Commission also, as part of its Dodd-Frank Act rulemaking, recently issued a rule proposal to modify the calculation of "net worth" for purposes of the "accredited investor" definition to exclude the value of an individual's primary residence when calculating

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[30] *See* Release No. 33-8878, *Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 and F-3* (December 19, 2007), http://www.sec.gov/rules/final/2007/33-8878.pdf.

[31] *See* Release No. 34-56887, *Exemption of Compensatory Employee Stock Options from Registration Under Section 12(g) of the Securities Exchange Act of 1934* (December 3, 2007), http://www.sec.gov/rules/final/2007/34-56887.pdf.

[32] Release No. 33-8891, *Electronic Filing and Revision of Form D* (February 6, 2008), http://www.sec.gov/rules/final/2008/33-8891.pdf.

[33] Release No. 33-8869, *Revisions to Rules 144 and 145* (December 6, 2007), http://www.sec.gov/rules/final/2007/33-8869.pdf.

[34] *See* Release No. 33-9178, *Shareholder Approval of Executive Compensation and Golden Parachute Compensation* (January 25, 2011), http://www.sec.gov/rules/final/2011/33-9178.pdf

net worth.[35] In developing the proposal, the Commission was mindful of the potential burden on small businesses and drafted the proposal to balance concerns relating to the impact on small businesses and the regulatory purpose of the proposal by allowing debt secured by an individual's primary residence, up to the value of such primary residence, to be excluded from the net worth calculation, thereby deducting only the equity value in the primary residence in the net worth calculation. Before we adopt the final rule, the Commission and staff will carefully weigh the public comments to ensure we strike the right balance.

Economic and Cost-Benefit Analyses and Expansions of the Private Markets

Economic and cost-benefit analyses are fundamental components of the rulemaking process and an essential part of the staff's work. The cost-benefit analyses included as part of all rulemaking releases typically are initially drafted by staff from the division or office responsible for the subject matter of the rule. The staff from that division or office who are most familiar with the details and intended operation of the proposed rule consult with the Commission's economists in Risk Fin (formerly OEA) to identify the proposed rule's possible costs and benefits, and to develop an analysis that takes into account the relevant data and economic literature. This collaboration, along with input from other divisions and offices, as appropriate, helps shape the draft economic and cost-benefit analyses included in any draft proposing release. Once senior members of the division primarily responsible for the rule and Risk Fin have reviewed this information, each of the Commissioners review and comment extensively on the draft proposing release. Ultimately, the proposing release, including the economic and cost-benefit analyses, is voted on by the Commission for release to the public.

The Commission invites public comment on all aspects of its proposed rules, including the cost-benefit and economic analyses, and seeks additional empirical data pertinent to these analyses. The rulewriting staff carefully considers all comments and data provided by the public, in close coordination with Risk Fin economists. The staff, along with each of the Commissioners, seek to arrive at a final analysis that takes into consideration the public comments and explains clearly the Commission's regulatory choices.

Your letter also asks whether a risk of diminished regulatory reach for the Commission or the expansion of private markets for accredited investors poses a conflict of interest that prevents the Commission from acting in the best interests of markets and investors. The short but definitive answer is no. In my experience both as Chairman and previously as a Commissioner,

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[35] *See* Release No. 33-9177, *Net Worth Standard for Accredited Investors* (January 25, 2011), http://www.sec.gov/rules/proposed/2011/33-9177.pdf. Section 413(a) of the Dodd-Frank Act requires the Commission to exclude the value of an individual's primary residence when determining if that individual's net worth exceeds the $1 million threshold required for "accredited investor" status. This change was effective upon enactment of the Act, but the Commission is also required to revise its rules to reflect the new standard. The Commission proposed rule amendments in January that would implement this provision, and would clarify the treatment of any indebtedness secured by the residence in the net worth calculation.

the Commission and its staff seek to act in the best interest of investors and the markets in all the decisions they make. Our mission is to protect investors, maintain fair and orderly markets and facilitate capital formation, and those overriding objectives are what guide our actions. Indeed, this letter clearly outlines actions taken by the Commission in recent years which I believe facilitated capital formation, improved secondary market liquidity and strengthened the private placement market, but which nonetheless resulted in a diminished regulatory role for the Commission.

Initial Public Offerings

The reasons a company may choose to undertake an initial public offering are varied and complex. The reasons often are specific to the company, with each company making the decision as to whether and where to go public based on its own situation and the market factors present at the time.[36] We appreciate that the costs and benefits of the regulatory actions that the Commission takes – and does not take – certainly can impact these decisions. The Commission seeks to minimize the costs of being a public company in the United States and provide a regulatory environment that encourages companies considering going public while at the same time maintaining important investor protections to ensure that investors can responsibly make capital allocation decisions. A vibrant initial public offering market requires that investors have the confidence to invest and that issuers view the benefits of conducting an initial public offering as outweighing the costs.

While the initial public offering market is not as robust as it has been during some periods in the past[37] – or as we would like it to be – it is difficult to identify with precision why any particular company decides to undertake an initial public offering or declines to undertake an offering. Approximately 11 percent of the new issuers filing registration statements for underwritten initial public offerings between January 2009 and March 2011 have withdrawn their registration statements. These companies cited a variety of reasons for terminating their offerings, including unfavorable market conditions, a decision to pursue a merger/acquisition strategy instead of an initial public offering, or simply a decision to not pursue an initial public offering at that time. One company stated that it was withdrawing its registration statement

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[36] *See, e.g.*, A.D. Pruitt, *Some Real-Estate Firms Make IPO U-Turn*, The Wall Street Journal, March 23, 2011 (outlining that real estate companies are choosing to not go public for a variety of reasons, including the return of other sources of capital, access to credit markets and the ability to sell assets to generate capital); David Weild & Edward Kim, Grant Thornton LLP, *Market Structure Is Causing the IPO Crisis — and More* (June 2010) (identifying a series of market structure issues, including technological, legislative and regulatory changes, which have resulted in the decline in the initial public offering market in the United States).

[37] *But see* PricewaterhouseCoopers LLP, *2010 US IPO Watch Analysis and Trends* (concluding that the U.S. initial public offering markets witnessed a solid recovery in 2010, deal activity in 2010 showed renewed confidence in U.S. initial public offering market, and factors driving 2010 initial public offering activity appear to foretell a healthy market heading into 2011).

because the benefits of being publicly traded were not sufficiently attractive to warrant proceeding with the initial public offering.[38]

The costs associated with conducting an initial public offering and becoming a public reporting company no doubt factor into the decision, and may be particularly challenging for smaller companies. As discussed above, we have taken steps in recent years to lower these costs, and, while more could potentially be done, it is clear that many small companies considering the costs and benefits have opted to access our public capital markets and enter our public reporting system. For example, in fiscal year 2010, approximately 40 percent of first-time registrants identified themselves as smaller reporting companies[39] under our rules, and a similar percentage of all of our reporting companies were identified as smaller reporting companies at the end of fiscal 2010. In fiscal year 2010, nearly half of the registered offerings conducted by first-time registrants (excluding offerings by asset-backed and investment company issuers), were to raise less than $10 million, and most of those were transactions in which less than $1 million was raised.

When companies believe the costs of being a public company are likely to outweigh the benefits, the owners are likely to decide to keep the company private. Some of these costs are likely to be more important than others. For example, most often, companies appear to cite the desire to maintain decision-making control and avoid ownership dilution as key concerns when contemplating an initial public offering. Companies also may worry about the potential costs of disclosing vital information publicly, which will become available to competitors. Recent research indicates that companies in industries where it is relatively easy for competitors to appropriate a company's intellectual property tend to remain private.[40] One study found that companies that had completed initial public offerings ranked the costs of SEC reporting requirements and officer liability introduced by the Sarbanes-Oxley Act of 2002 ("SOX") fairly low on the list of factors that affected their decision whether to conduct an initial public offering.[41]

A protracted decline in the stock market is likely to diminish the net benefits of an initial public offering and increase the attractiveness of remaining private. By the same token, availability of cheaper sources of funding (*e.g.*, public or private debt) might allow the company

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[38] *Telegent Systems, Inc.*, Registration Withdrawal Request (Form RW) (May 6, 2010).

[39] Smaller reporting companies are companies with less than $75 million in public float or, where public float is not calculable, less than $50 million in revenue for the last fiscal year. *See* Release No. 33-8876, *Smaller Reporting Company Regulatory Relief and Simplification* (December 19, 2007), http://www.sec.gov/rules/final/2007/33-8876.pdf.

[40] *See* J. Farre-Mensa, *Why Are Most Firms Privately Held?*, Working paper, Harvard University (2011).

[41] *See* J. Brau and S. Fawcett, *Initial Public Offerings: An Analysis of Theory and Practice*, Journal of Finance 61, 399-436 (2006).

to continue to grow while remaining private. Recent research also has shown that companies with less diversified controlling shareholders have comparatively more to gain from further shareholder diversification than those that already have diversified shareholders, and thus are more likely to go public. [42]

Timing also is of great importance. Companies tend to go public when business conditions are good, profitability and valuations are high, and the cost of capital is low.[43] Empirical evidence suggests that stock market valuations, industry conditions, and the need for capital to continue growing are the main factors that influence the timing of an initial public offering. A company might delay its initial public offering if it feels the market conditions are not favorable or investors are not willing to invest in certain types of businesses. Companies also tend to go public when companies with similar business models are overvalued and analysts may be overoptimistic about growth prospects of these companies.[44] Studies on withdrawn initial public offerings find that deteriorating market and industry conditions are by far the main reason for the withdrawal.[45]

Economic theory predicts that private early-stage or speculative growth companies that seek an initial public offering will have greater difficulty raising capital than otherwise similar publicly-traded companies. A variety of factors support this proposition. First, such early-stage/speculative growth entities do not disclose information regularly or on the scale that public companies do, increasing the information asymmetry between the management of these companies and their potential investors. Management could exploit this asymmetry to, for example, fund riskier projects than were promised to investors or exert lower effort, since investors could not monitor them in the way they could a public company. The risks associated with limited disclosure will tend to cause investors to demand higher incentives in return for providing their capital, increasing the cost of financing. In addition, early-stage/speculative growth companies generally have smaller and more variable cash flows than mature, public companies, limiting their ability to finance their growth from their own business operations. Finally, early-stage/speculative growth entities have a smaller asset base and larger percentage of

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[42] *See* A. Bodnaruk, E. Kandel, M. Massa, and A. Simonov, *Shareholder Diversification and the Decision to Go Public*, Review of Financial Studies 21, 2779-2824 (2008).

[43] *See* H. Choe, R. Masulis, and V. Nanda, *Common stock offerings across the business cycle: Theory and evidence*, Journal of Empirical Finance 1, 1-29 (1993); M. Baker and J. Wurgler, *The equity share in new issues and aggregate stock returns*, Journal of Finance 55, 2219–2257 (2000); L. Pastor and P. Veronesi, *Rational IPO Waves*, Journal of Finance 60, 17131757 (2005); W. Kim and M. Weisbach, *Motivations for Public Equity Offers: An International Perspective*, Journal of Financial Economics 87, 281-307 (2008).

[44] *See* R. Rajan and H Servaes, *Analyst Following of Initial Public Offerings*, Journal of Finance 53, 507-529 (1997); J. Ritter and I. Welch, *A Review of IPO Activity, Pricing, and Allocations*, Journal of Finance 57, 1795-1828 (2002).

[45] *See* J. Brau and S. Fawcett, *supra* Note 41.