

**NETWORK 1 FINANCIAL
SECURITIES, INC.**

October 20, 2011

Elizabeth M. Murphy,
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. 265-27
Advisory Committee on Small and Emerging Companies

Dear Ms. Murphy:

Network 1 Financial Securities¹ greatly appreciates the Commission's general invitation to the public to comment on the formation of the Advisory Committee on Small and Emerging Companies. Accordingly, we are please to take this opportunity to comment.

In brief, we believe that the funding source of choice for most new, start-up and incubator small business companies may not be adequately represented by the current composition of the Advisory Committee. Concretely, we believe that there are compelling reasons for including a transfer agent, a clearing broker/dealer, a trader or market-maker broker/dealer and a small-cap investment banking broker/dealer on the Advisory Committee for new, start-up companies.

In the meantime, Network 1 applauds the Commission's efforts at helping to achieve President Obama's economic objective of getting Americans back to work, especially through the instrumentality of resurrecting and growing small business in America.

1. **Network 1 Applauds the Commission's Efforts to Focus on Interests and Priorities of Small Business and Smaller Public Companies:**

The Commission has declared its intention to provide a formal mechanism through which it can received advice and recommendations specifically related to privately held small business and publicly traded companies with less than \$250 million in public market capitalization. Network 1 applauds the Commission's effort to focus on interests and priorities of small business and smaller public companies – the backbone of America's economy. As President Barrack Obama recently stated:

¹ Network 1 Financial Securities, Inc. is a full-service broker/dealer and FINRA member firm that is approved to engage in investment banking and private placement of securities in addition to other securities business. Network 1's investment banking clients include small business owners whose businesses involve technological, medical, and pharmaceutical products and services, *as well as businesses outside these target markets.*

*So America's small business owners -- people like Dave Sullivan [a small business owner seeking financing and mentioned earlier in the President's address] -- have always been the backbone of America's economy. These entrepreneurial pioneers, they embody the spirit of possibility -- tireless work ethic; simple hope for something better that lies at the heart of the American ideal. These are the men and women willing to take a chance on their dream. They've got good ideas and then they've got the drive to follow through. They've started mom-and-pop stores and they've got garages they open up and they start tinkering and suddenly that leads to some of America's biggest, most successful businesses. Ordinary Americans with a dream to start their own business, they create most of the jobs that keep our workers employed. In fact, over the past decade and a half, America's small businesses have created 65 percent of all new jobs in this country.*² (Emphasis supplied)

The practical problem for the small business owner – the entrepreneur whose company is not yet a public company -- is finding investors who can and will fund his business so that he can grow his business ultimately so that he can become the next Google or Microsoft.

2. **Compelling Reasons Why “Business Angels” and “Venture Capital Funding” Are Not Suitable for the Start-Up and Incubator Small Business Companies – Reasons Why Placement of Securities to Private Accredited Investors Is the Funding Source of Choice for Start-Up and Incubator Small Business Companies:**

In an article for Corporate Cashflow Magazine, Gary D. Zeune and Timothy R. Baer explained the nature of the small business man's funding problem and the practical solution to this problem:

Although most business owners dream of taking their company public someday, many have had to wait years for a traditional public offering. . . .For them, a *private placement of equity or debt has been a quicker, less expensive way to raise a limited amount of capital from a limited number of investors.* A private placement has been appropriate when a company still lacks the financial strength or reputation to appeal to a broad base of investors and cannot afford the expense of a public offering.³ (Emphasis supplied)

Private placements are considerably less expensive and less time consuming than other sources of funding (these “other sources” will be taken up in the paragraphs that follows). Moreover, private placements may be the only source of capital available to risky ventures or start-up firms because commercial bankers are often slow to lend to small businesses and start-up firms. Andrew J. Sherman echoes this point in his book, The Complete Guide to Running and Growing Your Business:

With loan criteria for commercial bankers and investment criteria for venture capitalists both tightening, the private placement offering remains *one of the most viable alternatives* for capital formation available to companies.⁴ (Emphasis supplied)

² Remarks by the President on the Economy, The White House, Office of the Press Secretary (May 13, 2010). <http://www.whitehouse.gov/the-press-office/remarks-president-economy> (last visited on October 20, 2011).

³ Quoted in E-Notes: Encyclopedia of Small Business | Private Placement of Securities (March 4, 2011). <http://www.enotes.com/small-business-encyclopedia/private-placement-securities/print> (last visited on October 20, 2011).

⁴ Id.

Aside from providing money to the small business owner, private placements offer invaluable intangibles: Private Placements enable the small business owner to hand-pick investors with compatible goals and interests. Since the investors in private placements are themselves generally sophisticated business people, private placements enable small business owners to structure more complex and confidential transactions. And, when the investors in private placements are themselves entrepreneurs, they may be able to offer valuable assistance to the company's management without necessarily sitting on the company's board of directors. Above all, private placements enable small businesses to maintain their private status.⁵

These and other rules of thumb are borne out by the United States Government Accounting Office.

Typically, business growth involves seven stages, having capital needs relevant to that stage, each stage having different sources of financing. According to the United States Government Accounting Office, the stages of business growth and corresponding sources of financing looks something like this:⁶

Stage of Development	Capital Needed	Financing Sources
Seed Stage: Capital needed to prove a concept or develop a product.	Up to \$250,000.00	<ul style="list-style-type: none"> • Entrepreneur's assets • Family • Friends
Start-Up Stage: Financing for product development and initial marketing	\$250,000 to \$5 million	<ul style="list-style-type: none"> • Business "Angels" • Early-stage venture capital • Small Business Investment Company • Foundation grants • Government Funds • <i>Private Placements</i>
First Stage: Investment to initiate commercial manufacturing, shipping, or service	\$1 million to \$5 million	<ul style="list-style-type: none"> • Business "Angels" • Small Business Investment Company • Venture Capital Funds • Research and development partnerships • Leasing companies • Strategic partnerships • <i>Private Placements</i>

⁵ Id.

⁶ Small Business: Efforts to Facilitate Equity Capital Formation, Report to the Chairman, Committee on Small Business, U.S. Senate, United States General Accounting Office (September 2000), at p. 9. <http://www.gao.gov/archive/2000/gg00190.pdf> (last visited on October 20, 2011).

Second Stage: Investment for initial expansion or production.	Up to \$10 million	<ul style="list-style-type: none"> • Venture Capital Funds • Corporate Venture Funds • Venture Leasing Companies • Strategic Partnerships
Third Stage: Investment for plant expansion, marketing, product improvement, or working capital.	Up to \$10 million	<ul style="list-style-type: none"> • Venture Capital Funds • Leverage Buyout Funds
Bridge Stage: Financing to sustain major growth in a company expecting to go public in 6-12 months.	Up to \$20 million	<ul style="list-style-type: none"> • <i>Private Placements</i> • Venture Capital Funds
Exit / Liquidity Stage via IPO, merger, or acquisition.	\$30 million or greater	<ul style="list-style-type: none"> • Public markets • Private markets

As this Matrix clearly evidences, Broker/Dealers that are authorized to act as Placement Agents play a critical role in *providing sources of funding* during the **Start-Up Stage**, the **First Stage**, and at the **Bridge Stage** in the development of small businesses.

But before we analyze the role that Placement Agents play in capital formation, it is worthwhile examining the “cost” paid by the small business owner when he goes the route of “Business Angels”, “Capital Venture Funding”, or “Small Business Investment Companies”, as these are the more typical *alternatives* to funding via private placement of securities offered through broker/dealers.

- **Business Angels:** While “Business angels” may be one funding option for the small business owner, this “option” more often than not is more “academic” than practical: Typically, in exchange for his investment, the “Business Angel” seeks to (a) take an active role in advising or even managing the firm, or (b) at a minimum, serve on the board of directors as a passive investor, but in any event (c) take 10 percent or more of a firm’s ownership; and (d) generally seeks the ability to liquidate the investment in about 5 to 10 years through a merger, acquisition, or IPO.⁷ Thus “Business angel” financing is not desirable for the small business owner seeking to maintain control over the day-to-day operation of the business he started, as well as seeking to keep his company private or at least taking his firm public on *his* time-table and *not the investor’s*. Accordingly, private placement financing is the more desirable option for this small business owner.
- **Venture Capital Funding:** Similarly, “Venture Capital Funding” can prove equally less than desirable for many, if not most small business owners. Typically, the venture capitalist seeks to provide incremental financing to small businesses *on the basis of the business’ achievement of specific financial and nonfinancial milestones*. The small business owner who started his own company may not want to voluntarily take on these constraints. Even if the small business owner

⁷ *Small Business: Efforts to Facilitate Equity Capital Formation, supra* at 10.

might be willing to agree to this concession, the typical small business owner will find other concessions equally, if not more, burdensome, such as the venture capitalist's desire to (a) take 20 to 40 percent ownership of a firm, depending on the amount of capital provided and their valuation of the firm; (b) have the right to liquidate the investment in about 3 to 5 years through a merger, sale, or IPO; and (c) have the right to advise and manage the firm by taking seats on the firm's Board of Directors.⁸ Once again, private placement financing is or may be the more desirable option for this small business owner.

- **Small Business Investment Companies:** Small Business Investment Companies⁹ could prove an option for the small business owner, so long as certain SBIC prohibitions do not apply to him or his business. Specifically, SBICs may not invest (a) in "other SBICs", in finance and investment companies; (b) in finance-type leasing companies; (c) in unimproved real estate, in companies with less than 51% of their assets or employees in the United States; (d) in companies that will use the proceeds to acquire farm land; (e) in companies whose primary business activity is deemed contrary to the public interest; or (f) in passive or casual businesses (those not engaged in a regular and continuous business operations). Thus, for example, a practicing physician who wants to start up new company separate from his medical practice in order to develop a medical treatment, such as a therapeutic ointment, might not qualify for an SBIC loan. Similarly, a start-up company seeking to offer certain foods or specially prepared foods (e.g., kosher or halal) unique to and currently unavailable to certain ethnic groups, would not likely be a candidate for small business investment company financing unless it is already a "going concern".¹⁰ Once more, private placement financing is or may be the more desirable option for this type of small business owner.

In short, *private placement* of securities is the *funding source of choice* for small business owners of *new, start-up* companies:

- Seeking an infusion of capital in an amount ranging from \$1 million to \$5 million,
- Without committing himself to having investors insisting that they be involved in the day to day affairs of the firm, or
- Without insisting that they sit on the board of directors as "passive investors to protect their investment", or
- Without demanding that the company attain prescribed benchmarks or that the company be taken public within a prescribed timeline that may prove to be an unreasonable business plan or not in the interest of existing stockholders.

⁸ Small Business: Efforts to Facilitate Equity Capital Formation, *supra* at 10-11.

⁹ Small Business Investment Companies or SBICs are privately owned and managed investment funds, licensed and regulated by SBA, that use their own capital plus funds borrowed with an SBA guarantee to make equity and debt investments in qualifying small businesses. The U.S. Small Business Administration does not invest directly into small business through the SBIC Program.

¹⁰ SBIC Program: Seeking SBIC Financing for your Small Business, <http://www.sba.gov/content/sbic-program> (last visited on October 20, 2011).

3. **The Funding Source of Choice for Small Business Owners of New, Start-Up Companies May Not Be Adequately Represented – And May Not Be Represented At All – By the Current Composition of the Advisory Committee:**

In an article addressing the three critical stages of development (start-up, incubation, and growth) published by one of the Committee members, the Author candidly states:

Now that you've written your business plan and lined up one or two key founders, the next step is to raise enough money to get going....Professional investors specialize to minimize risk, and they develop different paradigms based on their own circumstances. You can waste a lot of time dealing with investors who wouldn't invest in your kind of company anyway because it doesn't fit their profile with respect to size or risk/reward.... Banks, for example, almost never take risks because they typically make only 1% profit on their loans.... Even venture capitalists rarely venture outside the particular range of target companies in which they invest. They follow strict guidelines, some of which are established when the partnerships are formed....¹¹

The Author goes on to say that, at the start-up stage, the small business owner may want to “consider accepting investment from friends and relatives at this stage”. During the incubation stage, the small business owner will, generally speaking, not be attractive to the venture capitalist, but may be attractive to “angels”. The Author writes:

Chances are that [a \$250,000 capital raise] would be beyond the scope of the founders and their friends and relatives but not large enough to interest venture capitalist. Private investors, referred to as “angels” in the financial community, are a good source of funding for this level. Angels are often wealthy individual investors who dabble in high-risk startups after building successful businesses themselves. These people are optimistic. They can identify with what you do, help you by sharing their experiences, and give you credibility in raising additional capital. Some of them are even willing to combine their equity investment with a loan, thereby allowing you to retain a bigger portion of the company.... Some investment bankers can help you find these individuals, but as a rule you want to be extremely selective because most investors resent paying a broker's commission....¹²

Finally, there is funding at the growth stage. The Author states:

Venture capitalists are your most likely source of funding at this stage. They prefer investing in companies that can gain liquidity quickly.¹³

This otherwise well-written article begs the question for the new, start-up small company: *How do I find the money so that I can get to the point where my company can gain liquidity quickly; and, how do I do this without having outsiders sit on my board of director and take 10% or more ownership of my company?*

¹¹ See How to Find the Right Investors for Your Business: The Three critical stages of development – start-up, incubation, and growth – call for three different sources of funding. <http://www.lbl.gov/it/researchers/resourcespubs/investors.pdf> (iNCUBIC) (last visited October 20, 2011).

¹² Id.

¹³ Id.

With Venture Capitalists out of the picture at the incubator stage, the new, start-up small company is pretty much left with a solitary source of funding: Angels.

But, as previously stated, typically in exchange for his investment the "Business Angel" seeks to

- (a) Take an active role in advising or even managing the firm, or
- (b) At a minimum, serve on the board of directors as a passive investor, but in any event
- (c) Take 10 percent or more of a firm's ownership; and
- (d) Generally seeks the ability to liquidate the investment in about 5 to 10 years through a merger, acquisition, or IPO.¹⁴

Thus "Business angel" financing is not desirable for the small business owner seeking to maintain control over the day-to-day operation of the business he started, as well as seeking to keep his company private or at least taking his firm public on *his* time-table and *not the investor's*.

These factors, in turn, beg another question for the new, start-up small company: *Don't I have an alternative source for funding at the incubator stage?*

Industry participants know that there is. So does the Small Business Administration. As previously stated in the Matrix created by the Small Business Administration, *private placement* financing is the more desirable option for the small business owner at the start-up, incubator (or first stage), and bridge stages of small business development.

But, a cursory review of the Committee membership suggests that small business owners of new, start-up companies may not be adequately represented by the current composition of the Advisory Committee, and may even not be represented at all. Currently, the Committee is composed of the following representatives of the industry:

- There are two (2) law firms:
 - Fenwick & West and Shumaker
 - Loop & Kendrick, LLP
- There is one (1) accounting firm:
 - McGladrey & Pullen

Both, however, appear to have practices geared toward clients who have already crossed the threshold of being start-ups needing so-called seed money, and their representative clients suggest they are geared toward clients with higher-end technology, medical, and pharmaceutical targets. Equally important, there is a very sizable number of new, start-up small business owners whose businesses are *outside* the category of higher-end technology, medical, or pharmaceutical targets.

¹⁴ *Small Business: Efforts to Facilitate Equity Capital Formation*, *supra* at 10.

➤ There are eight (8) small or emerging companies on the Committee:

- Theragenics Corp.
- Tobira Therapeutics
- Exar Corp.
- Pipeline Software
- Tandy Leather Factory
- Zynga, Inc.
- PowerGenix
- Bluefly, Inc.

Continuing this theme that there is a very sizable number of new, start-up small business owners whose business are outside the category of higher-end technology, medical, or pharmaceutical targets, representatives of the higher-end technology, medical, and pharmaceutical businesses seem postured to dominate the business sector (as opposed to the legal/accounting, financial funding, investing, and regulatory sectors) of the SEC's Advisory Committee: Two (Theragenics Corp and Tobira Therapeutics) are in the biomedical / pharmaceutical industries, broadly speaking. Two (Exar Corp and Pipeline Software) are in the computer industry, broadly speaking. One (Zynga) is a children computer games programmer / developer.

➤ There are six (6) participants on the Committee who are involved in financial funding:

- iNCUBIC Venture Fund
- Highland Capital Partners
- Blue Tree Capital Group
- Northwest Indiana Bankcorp
- Rodman & Rehshaw.
- US Small Business Administration

The composition of the financial funding sector appears to be dominated by capital venture firms, venture capital affiliates, and "angels" – iNCUBIC Venture Fund, Highland Capital Partners, and Blue Tree Capital Group – whose target "small businesses" are companies that are well beyond the seed-money stage. The other financial funding source – Rodman & Renshaw, an investing banking firm – targets early stage companies; but, continuing the theme that there is a very sizable number of new, start-up small business owners whose business are outside the category of higher-end technology, medical, or pharmaceutical targets, Rodman & Renshaw's target companies are in the early-stage bio-technology and life-sciences.

Northwest Indiana Bancorp, a community bank, may postured to represent that very sizable number of new, start-up small business owners whose business is *outside* the category of higher-end technology, medical, or pharmaceutical targets. But, if the iNCUBIC article is correct – "You can waste a lot of time dealing with investors who wouldn't invest in your kind of company anyway because it doesn't fit their profile with respect to size or risk/reward.... Banks, for example, almost never take risks because they typically make only 1% profit on their loans...." – it is not so clear that Northwest Indiana Bankcorp will vocally represent the interests of the new, start-up small businesses in the start-up and incubator stage.

Then there is the Small Business Administration, a government agency that without question supports small businesses by locating lenders for small business owners. However, the SBA cannot and does not fulfill the *private placement* function that the SBA itself identifies in its Matrix.

- There are three (3) participants on the Committee who are involved in investing.
 - Wasatch Micro Cap is a mutual fund company.
 - Teacher Retirement System of Texas is a pension administrator.
 - State of New Jersey Division of Investment is also a pension administrator.

Clearly, none of these will or can legally fulfill the *private placement* function that the SBA identifies in its Matrix.

- Finally, there is one (1) participant on the Committee who is a securities regulator.
 - ✓ A. Heath Abshire, Esq. is the commissioner of the Arkansas Securities Department, the current Chairman of the Corporation Finance Section Committee of the North American Securities Administrators Association, and clearly not in a position to fulfill the *private placement* function that the SBA identifies in its Matrix.

In a word, there is only one participant on the Advisory Committee whose business or practice is dedicated to fulfill the *private placement* function that the SBA identifies in its Matrix – Rodman & Renshaw; however, this investment banker’s focus is limited to entrepreneurs in the early-stage biotechnology and life-sciences, leaving un-serviced the large number of small business owners whose businesses who are *outside* the category of higher-end technology, medical, or pharmaceutical markets.

It is therefore recommended that the Commission consider inclusion of additional participants on the Advisory Committee on Small and Emerging Companies. Specifically, Network 1 respectfully requests the Commission consider including:

- ✓ A broker/dealer¹⁵ whose FINRA approved business activities include investment banking for small-cap business owners whose businesses are *not limited to* higher-end technology, medical, or pharmaceutical investing and market targets.
- ✓ A broker/dealer whose FINRA approved business activities includes market-making trading.
- ✓ A transfer agent that has experience making Book-Entry-Only stock certificates eligible for deposit at The Depository Trust Company (“DTC”).
- ✓ A clearing broker/dealer that has experience in reviewing DTC eligible Rule 144 restricted stock for compliance with SEC, FINRA, and USA PATRIOT Act rules and thereby making these securities eligible for trading.

¹⁵ It is noted that, of the 21 members currently on the Advisory Committee, there is only one participant (John J. Borer, III) who is a registered representative of a FINRA member broker/dealer (i.e., Rodman & Renshaw).

4. **Compelling Reasons for Including a Transfer Agent, a Clearing Broker/Dealer, a Trading or Market Maker Broker/Dealer, and a Small-Cap Investment Banking Broker/Dealer on the Advisory Committee for New, Start-Up Companies Not Limited To Higher-End Technology, Medical, and Pharmaceutical Investing and Market Targets**

A. **Executive Summary:**

To put the matter simply, the chances for a small business owner's success in raising capital is directly contingent upon his investor's ability to deposit their securities for trading in the secondary market. This is critical, especially, for the small-cap business in the start-up and incubator stages of development – until this bridge is crossed, small business owners cross the threshold of the growth stage; and, until this threshold is reached, few (if any) capital venture and “angel” firms will cast a glance in the direction of this small business owner. Thus, the leap from start-up to growth financing is ultimately contingent upon the support network of (1) small-cap investment banker who, at the appropriate time, can make a market for the small business owner's securities, and (2) a clearing broker/dealer and/or transfer agent that has experience in, but also willingness to, assist in making the small business owner's securities “DTC eligible”, and (3) a clearing broker/dealer that has experience and willingness to clear Rule 144 stock once restricted stock legends are removed and the securities clear money laundering scrutiny.

The absence of small-cap investment banker, market-maker, transfer agent, and clearing broker/dealer on the Advisory Committee essentially rings a death knell for the small-cap business owner in the start-up and incubator stages of development.

Not only will a large majority of small business owners left out in the cold; but, so also a very large number of investors whose investment strategy and risk profile centers around investing in small but promising start-ups that may become the next Google or Microsoft.

B. **The Critical Process**

Small-cap companies that need or want to raise capital outside their small circles of family and wealthy friends and, at the same time, seek to avoid “passive” venture capital and/or “angel” investors on their boards of directors (who, once on the board, may decide to remain anything but passive over the direction of the company and even day-to-day operations) have the option of going the route of offering their company's securities via private placement through broker/dealers that are approved by FINRA to engage in investment banking.¹⁶

Generally speaking, many if not most small-cap companies in the start-up and incubator stages are in need of financing in the \$1 million to \$5 million range.

¹⁶ For the sake of those readers who are not familiar with broker/dealer compliance, the reader should know that not all broker/dealers that are registered with the Securities and Exchange Commission (“SEC”) and are members of the Financial Authority Regulation Authority (“FINRA”) are permitted to engage in investment banking. There is a new membership approval process via FINRA Rule 1013 and a continuance membership process via FINRA Rule 1017 during which time a broker/dealer may request permission to engage in investment banking and at the conclusion of which FINRA will either grant or deny permission. Many broker/dealers seek permission to engage in securities business (e.g., the sale of mutual funds, or variable contracts, or general equities) without seeking to engage in investment banking. In the end, a broker/dealer may not engage in investment banking unless FINRA approves this activity and memorializes this approval in a Membership Agreement with the applicant-broker/dealer.

Small-cap companies can achieve this objective by offering their company's securities to private investors who have neither interest nor desire to sit on the small-cap company's board of director (i.e., by investors who are neither "angels" nor venture capital investors.)

These investors have one objective only: They risk investing their money in a small, promising private company years at the *start-up and incubator stages* in exchange for the opportunity to receive a return on their investment when the company "goes public". Once a small, promising private company "goes public", these investors (who purchased shares for fractions of a penny in the primary market during the private placement offering) can now offer to sell their shares to other investors in the secondary market at a price that exceeds the private placement offering price for these shares.

Even if their shares trade in the secondary market at a penny or two above the fraction of a penny at which they purchased these shares, these private placement investors can profit substantially because, at a fraction of a penny, these investors routinely purchase a hundred, and even a thousand, shares for each dollar of investment.

This is the long-and-short of our American capitalist system that built our railroads, roads, bridges, and commercial empires in the 19th Century and our communications and computer giants in the 20th Century.

Most small-cap companies accomplish this "going public"¹⁷ goal by completing the 15c2-11 process.¹⁸

In return for investment dollars received from accredited investors during a private placement offering, small-cap companies routinely issue "book-entry-only" securities to investors – that is, physical stock certificates, instead of electronic journal entry recording, evidencing the shareholder's name and number of share ownership in the company. Typically, journal entry is cost prohibitive for small-cap companies at the start-up and incubator stages. In the most cost-efficient means available to both the small-cap company and its private investor, "book-entry-only" securities accomplish the objective of memorializing the investor's investment / ownership in the company.

Once the small-cap company is successful in "going public", the private investors' "book-entry-only" securities are postured for trading. One step remains: These "book-entry-only" securities need to be made "electronic".

¹⁷ Of course, a small-cap company, like any other company, can "go public" by filing an initial public offering ("IPO") registration statement with the SEC and then offering its securities to public (as opposed to private, accredited) investors. Because of the substantial expense involved in the IPO process, most small-cap companies seek an alternative. These companies can "go public" by getting listed directly on a securities exchange, such as the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and the National Association of Securities Dealers Automatic Quotations (NASDAQ). While less expensive than an IPO, many small-cap companies at the start-up and incubator stage may not yet be in a position to meet the asset and revenue requirements for getting listed on these exchanges. Thus, most start-up and incubator companies "go public" by getting listed on the Over-The-Counter Bulletin Board (OTCBB) or the Pink Sheets, since there are no asset or revenue requirements for getting listed on these exchanges.

¹⁸ The details of the 15c2-11 process are secondary to the main theme of this letter. However, a brief explanation may be helpful for some readers. 15c2-11 refers to the SEC Rule designed to allow the securities of non-reporting public companies to be quoted on FINRA's Over-the-Counter Bulletin Board ("OTCBB") by filing some certain disclosures, data, information, and documents about the company. A small cap company will file with FINRA a Form 211 that contains such disclosures, data, etc. If FINRA approves the small-cap company's filing, FINRA will issue the company a Stock Symbol thereby enabling the company's securities to be traded on OTCBB, and on the Pink Sheets as well.

C. The Problem

Since paper stock certificates cannot be transferred between buyers and sellers who own shares in “electronic format” in their brokerage accounts, to fix this problem the Depository Trust & Clearing Company (DTCC) was created. Since its inception in 1973, the DTCC has been providing the mechanism by which stock certificates are made “eligible” to be bought and sold through brokers and transferred from the seller’s brokerage account to the buyer’s brokerage account.

Everything has run smoothly for both the investor and the small-cap company, until recently. Something changed. Accordingly to *The LeBrecht Group*, a Professional Law Corporation:

... [H]istorically, approval by [the Depository Trust Company] was a matter of course after a company cleared SEC comments on its registration and statement and cleared FINRA comments on its 15c2-11. Once this occurred one of the company’s shareholders would deposit shares with their broker and the broker, at times with the company’s transfer agent, would apply for DTC-eligibility through a clearing firm affiliated with DTC. Once the request was granted the company’s shareholders could then buy and sell stock electronically through brokers. But this seemingly automatic approval by DTC is not occurring any longer for many small issuers, and many are having trouble even finding a broker and/or clearing firm even willing to submit the DTC-eligible application. Why? What happened?

According to *The LeBrecht Group*, the Regulatory Notice 09-05 issued by FINRA in January 2009 effectively lumped all small companies into a single class: Entities engaged in illegal, distributions of their companies’ unregistered securities. The reason for this “one-size fits all” assessment: Small companies lack long operating histories, and are therefore unworthy of being trusted. But, because FINRA has no jurisdiction over these small companies, but has jurisdiction over the clearing firms that deposit small company securities at the request of broker/dealers that raise capital in private placements and then assist these companies “going public”, this Regulatory Notice 09-05 is seen by clearing broker/dealers as a “shot across the bow”. Clearing firms see Regulatory Notice 09-05 as *identifying them as primarily liable* for that issuer or shareholder found to have conducted illegal, unregistered resale of the small company / issuer’s securities.

D. The Proposed Solution

Unless the Commission intends to exclude a large segment of the small business owners (and also investors in start-up and incubator small businesses), the Advisory Committee should make additions to its membership and include:

- A broker/dealer whose FINRA approved business activities include investment banking for small-cap business owners whose businesses are *not limited to* higher-end technology, medical, or pharmaceutical investing and market targets.
- A transfer agent that has experience making Book-Entry-Only stock certificates eligible for deposit at The Depository Trust Company (“DTC”).
- A clearing broker/dealer that has experience in reviewing DTC eligible Rule 144 restricted stock for compliance with SEC, FINRA, and USA PATRIOT Act rules and thereby making these securities eligible for trading.

- A broker/dealer whose FINRA approved business activities includes market-making trading.

D.1 Appointment of Investment Banker Whose Business Clients are Not Limited to Higher-End Technologies, Medical and Life-Sciences, or Pharmaceutical Investing and Market Targets.

Unless the Commission intends to focus the development of small business to higher-end technology, medical, and pharmaceutical market targets to the exclusion of small business outside these market targets, the Commission should consider including a **Broker/Dealer** whose FINRA approved business activities include **Investment Banking** for small-cap business owners whose businesses are *not limited to* higher-end technology, medical and life-sciences or pharmaceutical investing and market targets.

D.2 Appointment of Transfer Agent Experienced in “DTC Eligibility” Issues.

Precisely because the small business owner’s opportunity to transition from seed stage (self-funding or funding by friends and relatives) to start-up, as well as transition from start-up to incubator, and from incubator to the growth stage where venture capitalists can be successfully attracted is directly contingent upon attracting, at the start-up and incubator stages, private placement investors who have reasonable assurance that their stock certificates, issued by a *bona fide* small business companies, can be successfully deposited with a clearing broker/dealer for trading, a Transfer Agent that has experience making Book-Entry-Only stock certificates eligible for deposit at The Depository Trust Company (“DTC”) should be included in the membership of the Advisory Committee. Currently:

- There appears to be a blanket freeze on allowing all small-cap company securities to become “DTC eligible”, simply because they are start-up or incubator development stage companies.
- Companies that were once “DTC eligible” now seem to be subject to removal, and many have been removed, from “DTC eligibility” because of reverse merger or company reorganization.
- It is impossible to trade stocks of small-cap companies in the secondary market in the absence of their securities being DTC registered.
- In short, it is impossible for investment bankers to raise capital from small-cap businesses at the start-up and incubator stages of development because, in the absence of being able to deposit the securities of these companies for trading, these securities are illiquid.

The appointment of a **Transfer Agent** with long-time experience dealing with “DTC eligibility” issues will greatly advance the cause of identifying rationale and reasonable criteria for approving bona fide small-cap company securities for “DTC eligibility”. Such transfer agent can play an instrumental role in recommending to the Commission protocols that can be memorialized as “industry standards” so that broker/dealers can follow and properly counsel small-cap businesses during the investment banking process.

D.3 Appointment of Clearing Broker/Dealer with Experience and Willingness to Deal with Small-Cap Investment Bankers, Market Makers, and Rule 144 Stock Resale Issuers.

Securities made “DTC eligible”, of course, remain without value to private placement investors, and therefore valueless to the small-cap companies focused on obtaining venture capital at the growth stage, if there is no clearing broker/dealer willing to accept these securities for deposit. Understandably, almost all

clearing firms are reticent about depositing securities of these companies since, in the recent past, a small number of clearing broker/dealers have been sanctioned by regulators for allowing non-bona fide small companies or their investors to trade these securities in money laundering schemes.

However, the solution to this problem is not exclude the entire universe of small-cap companies, their investors, and privately issued securities from America's capitalist system. Analogously, it would make little sense to jettison our democratic-republican form of government when there is an abuse of liberty by a few of our Country's citizens.¹⁹ If the object of the Advisory Committee is, truly, to create a formal mechanism through which the Commission can receive advice and recommendations specifically related to small business, as well as publicly traded companies with less than \$250 million in public market capitalization, then the Commission needs to consider including among its Advisory Committee membership a **Clearing Broker/Dealer** that:

- Has extensive experience and an established track record for monitoring "red flags" for money laundering in small-cap securities.
- Has extensive experience reviewing DTC eligible Rule 144 restricted stock for compliance with SEC, FINRA, and USA PATRIOT Act rules and regulations.
- Has an expressed willingness to cooperate with capital raising efforts through private placements investment bankers, and not just public securities offerings by the larger investment bankers.
- Has an expressed willingness to identify rationale and reasonable criteria for depositing Rule 144 securities whose restrictive legends have lawfully entitled to be removed.
- Has an expressed willingness to recommend to the Commission protocols that can be memorialized as "industry standards" for acceptance for deposit and for trading of Rule 144 securities whose restrictive legends have been legitimately removed.

D.4 Appointment of Makers of Markets in Privately Issued Securities that Become Eligible for Trading When In Compliance with Rule 144.

Finally, since market-making is the consummation of the investment banking process, the absence of a **Market-Maker Broker/Dealer** on the Advisory Committee is fatal. The second element of the Advisory Committee's mission, as well as that of the Commission, is to *protect the investor*, as well as support capital formation.

¹⁹ James Madison and Alexander Hamilton taught valuable lessons that have relevance for discussion about governance in the securities market place.

In Federalist Essay #10, Madison teaches: If you are going to have limited government, a premium must necessarily be placed on individual liberty, recognizing that with the blessings of liberty inevitably come many "mischiefs". To cure this "mischief", governing bodies have a choice: They can either *remove the cause* of these "mischief" or they can make a good faith effort to *control their deleterious effects*. Madison cautions against resorting to the first solution because this remedy is worse than the disease.

In his various economic reports on manufactures, banking, and the public credit, Hamilton teaches: If you are going to have limited government that is *dedicated to economic freedom for the common good*, you must give *freedom to the ruling passion* (e.g., the spirit of acquisitiveness) *that drives the individual citizen* in market place.

This Country was built on the "acquisitive spirit" and protecting this spirit (i.e., controlling the harmful effects rather than removing the cause of "mischief" attending to this spirit) is the business of governing bodies in the securities market place.

It is indeed ironic that there is a certain class of professional investors in America whose investment has gone unprotected and will continue to go unprotected if the Commission does not offer a solution to trading privately placed securities purchased by the professional private placement investor.

Moreover, if the professional private placement investment community gets the sense that he/she/it will never be able to deposit and trade his/her/its Rule 144 securities (even if all conditions and requirements of Rule 144 are fulfilled) simply because the recipient of his investment dollars is a small-cap company at the start-up or incubator stage:

- The professional private placement investor realizes that his/her/its investment protection is substantially different or even non-existent as compared to the retail investor.
- The professional private placement investor will come to realize that he has no potential for deposit and resale of the private placement securities he purchased.
- The professional private placement investor will take his investment dollars off-shore.
- Capital for the small-cap company in America will dry up.
- The small-cap business owner at the start-up and incubator stage will suffer irreversibly.
- President Obama's mission to stir small business leading to creation of hiring that established companies refuse to undertake.
- The Commission may very well fail in its expressed mission to resurrect capital formation while protecting the investor.²⁰

Until recently, Market-Makers have been the instrumentality for the capital raise process from beginning to end -- from start-up to incubator stage, and from incubator to growth stage for every small company.

Increasing numbers of broker/dealers, following in the footsteps of the clearing firms, no longer accept stock certificates from customers. The broker/dealer world is decentralized, particularly in the market making arena. Yet, the market-maker is the final piece in the investment banking process on which the small-cap start-up and incubator company is so dependent both for immediate and future success.

For this reason, it is essential that the Commission consider including among its Advisory Committee membership a **Broker/Dealer Market-Maker**.

CONCLUSION

It bears repeating: The abuses of some should not be an indictment of the system or an entire segment of the system. Network 1 agrees with A. Heath Abshire, Esq (Commissioner of the Arkansas Securities Department, current Chairman of the Corporation Finance Section Committee of the North American

²⁰ Governance aims simultaneously at two principles: Justice, but also Practicality. Justice is represented, symbolically, by scales balancing conflicting interests. Here, "investor protection" must be balanced with "capital formation", requiring a *practical* exercise of judgment that takes into consideration the *realities of business*.

Securities Administrators Association, and member of the Commission's Advisory Committee), when he states that "mom and pop" have no business buying or being sold private placement of securities.²¹

Small investment banking firms want privately placed securities sold only to accredited and sophisticated investors. The small investment banking firm's ability to survive another day to conduct another capital raise for small-cap businesses rises and falls on privately placed securities being offered and sold to these professional investors.

There are remedies for both investors and regulators within the existent legal system to correct abuses.

The exclusion of an entire segment of the small-cap business universe (start-ups and incubator stage companies) from representation on the Commission's Advisory Committee should not be adopted as additional remedy for such abuses. Not only lacking in proportion to such abuses, it seems discriminatory against small-cap businesses in the start-up and incubator stages, if not also punitive against small investment bankers and market-makers who service these small-cap businesses.

Network 1 believes that the better course is to search for solution for the *entire* investment banking universe that services all small-cap companies (start-ups and incubators, as well as growth companies), as well as small-cap companies whose businesses are *not limited to* higher-end technologies, medical and life-sciences, and pharmaceutical investing and market targets.

Towards this end, Network 1 respectfully recommends that the Commission include among its Advisory Committee membership:

1. A broker/dealer whose FINRA approved business activities include investment banking for small-cap business owners whose businesses are *not limited to* higher-end technology, medical, or pharmaceutical investing and market targets.
2. A transfer agent that has experience making Book-Entry-Only stock certificates eligible for deposit at The Depository Trust Company ("DTC").
3. A clearing broker/dealer that has experience in reviewing DTC eligible Rule 144 restricted stock for compliance with SEC, FINRA, and USA PATRIOT Act rules and thereby making these securities eligible for trading.

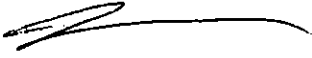
²¹ Commissioner Absure testified before Congress on September 17, 2011, stating: "The critical questions are: Have [traditional] sources [e.g., friends, family, home equity loans, bank loans, nonbank loans, angel investors, venture capitalists, and private and government investors providing SBA-sponsored financing] stopped funding small business? ... If the answer is that funding is not available because banks are not lending as they should, or because traditional sources of small business capital are unavailable even to even well-qualified, established, or very promising small business endeavors, then this has the potential to stifle small business growth and hurt the economy....On the other hand, if the answer is that traditional sources of small business capital have reviewed the particular small business applicant and determined that the risk is too great, then we should not allow that applicant to seek investment from unsophisticated, "mom and pop" investors without appropriate investor protections. The typical retail investor, unlike the traditional small business financier, does not have the ability to conduct a reasonable investigation of a start-up or development-stage entity.... [Congress] must ensure that [small capital formation] methods are available only to those entities that need it, rather all that profit from using it.... If the point is that small businesses should be entitled to a different regulatory approach than larger businesses, any special treatment should be limited to the appropriate small business issuer." Testimony of Heath Abshure, Arkansas Securities Commissioner and Chairman of the Corporation Finance Section Committee, North American Securities Administrators Association, Inc. Before the House Subcommittee on Capital Markets and Government Sponsored Enterprises "Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation" (September 21, 2011) <http://financialservices.house.gov/UploadedFiles/092111abshure.pdf> (last visited on October 20, 2011).

4. A broker/dealer whose FINRA approved business activities includes market-making trading.

Respectfully submitted,

NETWORK 1 FINANCIAL SECURITIES, Inc.

By:



Damon D. Testaverde,
Manager
Investment Banking Department