THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

ADVISORY COMMITTEE ON SMALL AND EMERGING COMPANIES

MEETING

Wednesday, September 13, 2017

9:39 a.m.

Multi-Purpose Room LL-006

100 F Street, N.E.

Washington D.C.

Diversified Reporting Services, Inc.

(202) 467-9200

APPEARANCES:

Stephen M. Graham, Advisory Committee Co-Chair
Sara Hanks, Advisory Committee Co-Chair

Current Members of the Advisory Committee:

Robert Aguilar
Xavier Gutierrez
Brian Hahn
Catherine V. Mott
Jonathan Nelson
Patrick Reardon
Lisa Shimkat
Annemarie Tierney
Gregory C. Yadley
Laura Yamanaka
J. W. Verret (Appointed June 1, 2017)

Non-Voting Members:

Michael Pieciak
Joseph Shepard (appointed May 9, 2017)

Other Securities and Exchange Commission Staff:

Michael S. Piwowar, Commissioner
Jay Clayton, SEC Chairman
William H. Hinman, Director of Corporate Finance

APPEARANCES, CONT:

Other Securities and Exchange Commission Staff(cont.):

Robert Evans, Deputy of Legal and Regulatory Policy
Elizabeth Murphy, Associate Director
Sebastian Gomez Abero, Chief, Office of Small Business Policy, Division of Corporate Finance
Julie Z. Davis, Senior Special Counsel

A G E N D A

9:30 a.m. Co-Chairs Call Meeting to Order
Introductory Remarks by Chairman Clayton & Commissioner Piwowar

10:00 a.m. Auditor Attestation Report under Section 404(b) of the Sarbanes-Oxley Act
Presentations:
Leonard L. Combs, PwC, U.S. Chief Auditor
William J. Newell, Chief Executive Officer, Sutro Biopharma, Inc.
Committee Discussion

11:30 a.m. Final Report of the Advisory Committee to the Commission
Discussion and Vote on Adoption

12:30 p.m. Lunch Break

A G E N D A (CONT.)

2:00 p.m. Awards Pursuant to Written Compensatory Benefits Plans - Should Securities Act Rule 701 Be Updated?
Presentation:
Christine McCarthy, Partner, Compensation Benefits, Technology Companies Group, Orrick
Steve Miller, Chief Financial Officer, Warby Parker
Committee Discussion

3:30 p.m. Adjournment

PROCEEDINGS

CO-CHAIR GRAHAM: Could I get people to take their seats? Well, welcome everyone. Good to see you all. Sebastian, I believe we have a quorum.

MR. GOMEZ ABERO: We do.

CO-CHAIR GRAHAM: Okay. As you know, the two-year term of this Committee's charter expires September 24, so this will be our last meeting. We have drafted a final report to memorialize the recommendations made by the three iterations of this Committee over the past six years, and just as importantly, to identify areas we recommend for continued focus. We will take up that report later this morning.

Our first item of business this morning will be the Auditor Attestation Required by SOX 404(B). This is a topic we have touched on previously and today, I hope we can get into it in more depth. This afternoon, we'll discuss Securities Act Rule 701, an exemption that many companies use to grant options and other equity-based compensation. The ability to attract and retain talent by giving employees and other key people a stake in the business is critical for emerging businesses. As companies are staying private longer, it is important to take a look at this rule to see if modernizing amendments might be in order.

We have a new member to introduce, J.W. Verret, is J.W. here? Hello, sir. Welcome. J.W. is an associate professor at Antonin Scalia Law School, which is at George Mason University. He's also a senior scholar at the Mercado Center Working Group on the Financial Markets. It's a little bit like being drafted on the last day of the war, but it's (laughter) -- before we move further into our agenda for the day, we are very pleased to have Chairman Clayton and Commissioner -- not yet Commissioner Piwowar. He's --

MR. GOMEZ ABERO: He's trying to avoid the draft.

CO-CHAIR GRAHAM: So I will then turn it over to our Chairman.

CHAIRMAN CLAYTON: Thank you, Steve and Sara and all of the members of the Committee. Good morning. I'd also like to join Steve in extending a warm welcome to J.W. And as Steve noted, the two-year term of this Committee expires on September 24th. I want to extend my sincere appreciation to all of you for your dedication in service. Your recommendations have been and will continue to be helpful as we work to facilitate the ability of small and emerging companies to raise capital.

In my short time here, I've already come to appreciate the insights and expertise that this Committee

brings to bear. I'm going to deviate a bit from my prepared remarks and just say the perspectives that we hear from you and your real world perspectives and others, matter a lot. We recently traveled to St. Louis and did a roundtable with what I call Main Street investors. Having their perspectives in mind as we craft investor protection rules is very important. Yesterday, we had a VC group in here and where's Raquel? Raquel said you have to come in and hear this, you know, the state was that the Midwest is somewhere between the 5th and 10th largest economy in the world.

Over 100 Fortune 500 companies, but only four percent of US venture funds. Doesn't make sense that you would have that robust an economy and so few people looking toward the future. And we should have that in mind as we think about some of the issues that we're going to talk about today.

So it matters to hear from you, and let me go back to my prepared remarks. I don't think -- Bill, I don't think I had a material, you know -- I don't -- I don't think there'll be a material omission as a result of those comments.

MR. HINMAN: We'll review it. (Laughter)

CHAIRMAN CLAYTON: Well, thank you. This Committee has long been recognized and appreciated, so

much so that Congress recently codified the Committee into the Exchange Act. I'm pleased to announce that the Commission is moving forward on establishing this permanent successor Committee, which will be named The Small Business Capital Formation Advisory Committee. I am thankful, and you and others have served in this Committee should be proud that the thoughtful dialogue and recommendations that you have had have led Congress to take this action.

Along those same lines, today, we published a nationwide job search for the new advocate position. I think the timing is good. It should've hit the wires, and we look forward to getting that person onboard. If you have people you want to nominate, nominate them. We want to -- we want to have a robust applicant pool.

So today's agenda, Steve covered it well. It's clear that you guys are not slowing down. You're exploring two very important areas for small and emerging companies, and I look forward to hearing your views.

You'll take up the discussion of 404(B). Here, I want to note that we recently proposed amendments that would increase the financial thresholds for smaller reporting companies and thereby expand the number of companies that could qualify for scaled disclosures.

We've received a number of thoughtful comments

on this proposal and we look forward to hearing your discussion and, as always, any data and experience you can share. This afternoon, we'll include a discussion of potential updates to modernize Rule 701, which is an exemption from registration for securities issued by non-reporting companies pursuant to compensation arrangements. In essence, it's a rule that makes it less burdensome to compensate employees with equity.

The Commission last adopted substantive amendments to this rule in 1999. Since that time, many companies have chosen to stay private longer and have higher valuations and our markets have changed in other ways. In light of these developments and recent legislative efforts related to this rule, including yesterday, I'm interested to hear whether this Committee believes Rule 701 continues to appropriately serve both the needs of employee investors who receive compensatory awards and the needs of non-reporting companies.

I also look forward to reading the Committee's final report that you are discussing today, as the Commission explores ways to improve the attractiveness of being a publicly listed company while maintaining important investor protections. Your recommendations will continue to be instrumental. I'm going to slow down here. (Laughter) Your timing is perfect.

MALE SPEAKER: That's right.

CHAIRMAN CLAYTON: You're always perfect. You're always perfect. Thank you, again, for your service to this valuable Committee, and I hope you enjoy a productive day. Right on time.

COMMISSIONER PIWOWAR: My turn?

CHAIRMAN CLAYTON: Yes.

COMMISSIONER PIWOWAR: Man, I don't even get to rest. I just sit down and go ahead and speak. So good morning and warm welcome to everyone on the Committee, including our newest member of the Committee, Professor J.W. Verret, a good friend of mine from George Mason University's Antonin Scalia Law School.

Today, we bid a fond farewell actually to the Committee, which is convening for the 22nd by my count and final time.

CO-CHAIR GRAHAM: Yes.

COMMISSIONER PIWOWAR: 22nd or 23rd. I think we've met 22 times.

MR. GOMEZ ABERO: It depends on whether you count the telephone meetings as well or not. (Laughter)

COMMISSIONER PIWOWAR: No.

MALE SPEAKER: We're not going to have --

COMMISSIONER PIWOWAR: If you count those, we're at like 150, I think.

MALE SPEAKER: -- we're not going to have a 404 attestation on that today. (Laughter)

COMMISSIONER PIWOWAR: You're close enough, that's good. So since your first meeting, I believe it was on Halloween 2011, you've enlivened policy discussion and debate within our agency, and you've produced numerous recommendations, each of which, whether adopted or not, has informed and sharpened the Commission's analysis of its mission with respect to small and emerging companies. I'd like to take this opportunity to commend the members of this Committee for the service that some of you have rendered for the entire six years and for -- and for a number of you, for a good portion of that time.

It has long been remarked that we Americans distinguish ourselves by our willingness to participate in voluntary organizations dedicated to the common good. As Alexis de' Tocqueville, famously remarked, "Americans of all ages, all conditions and all dispositions constantly form associations. Wherever the head of some -- at the head of some new undertaking, you see the government in France, a man of rank in England, and in the United States, you'll be sure to find an association," or Committee.

In attending these quarterly meetings of your

association and your monthly conference calls, in drafting and revising the text of your many recommendations, in putting aside faction in the interest of civic duty, you have acted in the very highest motives. You have provided invaluable service to our country without prospect of fame or fortune.

You have marshalled your expertise to the -- to benefit entrepreneurs and innovators who may never know the service you've done them but whose future successes will contribute to the flourishing of our country.

As Chairman Clayton just announced -- I hope you just announced before I walked in, the SEC is launching a nationwide search to hire the Agency's first ever advocate for small business capital formation. By statute, the applicate must be chosen from outside the ranks of current SEC employees and I hope that you all -- you all will encourage strong candidates to apply for the position. I hope, too, that I will continue to see some of the faces gathered here on the new Small Business Capital Formation Advisory Committee whose establishment lies in the not too distant future.

And in closing, as Edmund Burke wrote, "To be attached to the subdivision, to love the little platoon we belong to in society is the first principle of public affections. It is the first link in the series by which

we proceed towards a love of our country and to mankind." At the risk of sounding a little sentimental, this Committee, your little platoon has been the vehicle by which you have shown both your patriotism and your professionalism. On behalf of my fellow commissioners, past and present, I thank you for your service and I look forward to your continued contributions in the years to come. Thank you all.

CO-CHAIR GRAHAM: Thank you, Commissioner. I should say that Commissioner Stein would like to be here. She's travelling. She sends her regrets.

We want to briefly acknowledge the SEC Staff at the table from the Division of Corporation Finance, and so I'd like to turn it over to their leader, Bill Hinman, who will introduce the others.

MR. HINMAN: Sure thing. Thank you, Steve and Sara for your leadership of the Committee and your work on the Committee. It's been very valuable. I regret that this is the only meeting I will be able to attend, my first or last, but with my staff, I've heard a lot about the work you've done and have been very impressed and very thankful for the efforts you all made. And thank you, again, for your service. Let me echo that.

Unfortunately, I won't be able to stay with you very long today. I am actually traveling to some other

groups to meet with some other groups, the Council of Institutional Investors in California and the American Bar Association Business Group in Chicago on the way back. As part of our effort to get input from a wide range of constituents and interested parties and, as has been mentioned, that input from groups like this and others is extremely valuable to us. So the topics you have today are right in our wheelhouse. We've been having meetings on a number of the things that you'll be covering today and I'm looking forward to hearing part of it and reading some other reports that you've generated so thank you for that work.

Let me acknowledge our staff that are here today. You know many of them and have worked with them, but we do have one new member, Rob Evans, our new deputy of Legal and Regulatory Policy. On my right, I think you all know Betsy Murphy, one of our associate directors, who has oversight of the Small and Business Policy Office. The head of that office, Sebastian Gomez Abero, who I know you all think fondly of, and I know he has enjoyed his work with this Committee and has spoken highly about that to me.

And finally, Julie Davis here, our senior special counsel in that office. Again, someone I'm sure you know well. I don't want to have any material

omissions, so let me say the standard disclaimer, the folks on the staff that will speak today are giving their own views, not those of the Commission or any other members of the staff. And with that, let's kick it off. Thank you.

CO-CHAIR GRAHAM: All right. Thank you, Bill. And on behalf of the Committee, I, too, would like to thank the staff for their tireless efforts. It's -- we do respect your work and it is much appreciated.

(Applause)

So let's go to 404(B), and with that, it's all yours.

CO-CHAIR HANKS: All right. Are we going to bring up our witnesses? Speakers -- witnesses (laughter). This is just too Washington sometimes. Thank you speakers.

As Chairman Clayton mentioned earlier, in June, the Commission proposed amendments to increase the public float threshold. That's the threshold at which companies can qualify to provide scaled disclosures, smaller reporting companies. That proposal would raise the threshold in the definition from $75 million to $250 million, and that is something that this Committee has been very much in favor of. The release discussed but did not propose to similarly raise the current $75

million threshold, at which a registrant's auditor must attest to and report on management's assessment of a company's internal controls. Now, this is an incredibly important thing. Financial statements are, of course, the essence of company disclosure, but it's also something that is pretty burdensome at times and those of us, as the Chairman mentioned, with real life experience have come across this.

This auditor attestation requirement of Sarbanes Oxley 404(B), SOX 404, is something we've discussed previously. It's one of the requirements from which the emerging growth companies are exempt for a five-year onramp, pursuant to the Jobs Act. The release asked for comments and data on several alternatives. One of which would be to extend the SOX 404(B) exemption to all registrants that are eligible for and claim reporting company status. In keeping with this Committee's continuing and everlasting thirst for quantitative data, we wanted to look into the costs that smaller companies incur in complying with SOX 404(B), so we've brought in some additional expertise. First, I'd like to introduce Leonard L. Combs, PwC's US Chief Auditor.

Len has more than 25 years of public accounting experience and now oversees PwC's audit policies and practices. Before joining PwC's national office, he led

their pharmaceutical life science and technology practice in Philadelphia. He is also a member of the PCAOB's standing advisory group.

Next to Len is William J. Newell, Chief Executive Officer of Sutro Biopharma Inc. Located in San Francisco, Sutra is a private company that discovers and develops cancer therapeutics. Prior to joining Sutra in 2009, Bill had years of senior management experience with established publically traded firms in the biotech industry and prior to that, he practiced law for 16 years. He's also a board member on the trade association bios, emerging companies section. We appreciate very much having both of you here today and to help us delve into this important topic. Please take it away.

MR. COMBS: So thanks, Sara, for the introduction, and thanks for the opportunity to come and share our perspectives. I was asked to come to talk about the evolution of the audit of internal controls under 404(B), as well as as auditors, how do we think about going about doing that audit, and then certainly, give our perspectives on the benefits. Certainly over the past, you know, 10 to 15 years, Sarbanes Oxley and the application thereof has evolved. We've certainly seen many of the benefits of those, broadly speaking, so greater accountability on behalf of management and the

auditors, improved transparency and certainly the trend on restatements is certainly encouraging as the quality of financial reporting and auditing has improved over a number of years.

You know, that being said, there is a cost of being a public company, right? Whether it's, you know, higher director fees, higher fees paid to management, external auditors, legal costs, you know, so I certainly acknowledge, you know, that this needs to be carefully considered as we, you know, think about regulating and absolutely recognize there is a cost of this, including the cost of doing 404(B), so that's kind of undeniable.

So then, we'll go into talking about how we think about it, our perspectives on how we do that audit, what's changed from the standpoint of SEC regulation, PCAOB regulation and some other helpful guidance that's been issued over a number of years and the benefit that that's provided.

So just to, you know, level set with everyone, and I know Bill's going to talk about some of the criteria of how, you know, you fall out of the non-accelerated filer status and, therefore, require a 404(B) audit to be done by your auditors, but as we think about the population, right now, about 50 percent of all public companies have non-accelerated filer status, meaning

there's no obligation or requirement on behalf of the auditors to audit internal controls based on, you know, the current requirements. Certainly some of that importantly was driven by the Jobs Act, and I think Bill's going to talk about that fact that, you know, many of the companies that filed under the Jobs Act are now coming to the end of -- end of that horizon and timeframe, so important considerations to think about.

So if we go back and talk about the history a little bit of 404(B), certainly, you know, when auditors and management teams first had to assert to the effectiveness of controls and then auditors had to attest to the effectiveness of controls back in 2004, the cost and the changes were significant, no denying that. As time has progressed, I do believe, you know, management -- I do believe auditors have gotten better at doing control audits and understanding their control environments and certainly doing better risk assessments and importantly integrating, you know, the audits between a financial statement audit and the audit of internal controls.

The SEC and the PCAOB, as I talked about, undertook some important rule-making that came to fruition in 2007, which I'll talk about in a little bit -- in a little bit more detail, but really focused on

right sizing the amount of work that management had to do, as well as right sizing the amount of work that auditors needed to do in order to opine on internal controls and certainly for a second time, we did see a fairly significant decline in the cost of auditors doing the audits as well as the cost of the -- the internal cost management faced and the cost that they were paying third parties, you know, to comply -- help auditors comply with the requirements of 404(B).

So the end results of those efforts were, you know, an integrated audit whereby we believe, at this point in time, the incremental cost of doing a 404(B) audit in the context of the overall -- the integrated audit is certainly a fraction of what the overall cost doing the audit -- said another way, you know, we don't think this is a one-plus-one equals two, when you think about the cost of doing a 404(B) audit, but again, the incremental cost relating to solely auditing internal controls is a fraction of the overall cost and certainly, and importantly, that does vary by size of company, so you know, for much larger, much more complex companies, it's probably a smaller percentage of the overall cost, too -- and -- but as you go down the curve and you get to a smaller sized company, the percentage of those fees are probably -- certainly probably a bit higher.

So on this next slide, and I'm not going to take you through the gory detail of this, but the SEC and the PCAOB, you know, did focus on important reforms that we believe are helpful. The punchline of this is we do believe the revisions to the requirements did really drive scalability of the audit, allowed much more flexibility and judgement on behalf of management, you know, and the auditors. It drove importantly the ability for both to really focus on the risk assessment and focus on those areas that were most likely to result in, you know, potential material misstatements to the financial statements. So as I said again, as a result of the efforts in 2007, again, an important decline in the overall cost of compliance.

So let me briefly turn to talk about what we do in an audit, both a financial statement and audit and an integrated audit, which includes auditing internal controls under 404(B). And my intent here today is certainly not to make you experts in auditing, we'd be here for a while, but rather to really demonstrate and discuss how many of the procedures that we do for a 404(B) audit are consistent with what the requirements are for a financial statement audit. And they really piggyback off each other. So when we think about planning the audit, the way we establish materiality and

those things we're going to focus on is the same between the financial statement audit and an audit of internal controls.

Our risk assessment procedures, where we really try to understand the company, its environment, understanding the processes and controls that are in place, which we need to do, whether we do an integrated audit or we do a financial statement only audit so that doesn't change, as well as the other overall risk assessment and planning the audit really is the same between, you know, both audits as we go through it.

When we think about what are those things we need to audit, so significant accounts from either a financial statement or audit or internal controls audit, they are the same between the two. And this is really where scalability starts coming in, to the extent that something's not, you know, applicable to -- for example, a precommercial entity, certainly we're not going to look for controls over, you know, revenue and audit controls over revenue when we're in -- when a company's in a precommercial stage. So that really, you know, for both financial statement and integrated audit, allows us to really scale the audit, determine what we need to do based on the risk presented by a specific company -- within a specific company.

So again, not to go into the gory detail, but when we think about the audit of ICFR, we certainly identify the controls that are relevant to the risks presented in the financial statements. And I think we went -- we went blank up there. I'm not sure what -- so it focuses on those risks that are relevant to that particular company and what could represent a material misstatement if those controls don't operate effectively.

We think about it from a top-down standpoint and certainly design our audit opinion based on that. You know, in many cases, whether it's a audit of internal controls or solely a financial statement audit, we will look to audit the controls anyway because if we assess the design of the controls and we determine those controls to be effective and we can test those, often, we can think about reducing the amount of work that we do on the financial statement audit.

So then this really gets to the point about integrating the audits to the extent that we look at the controls, they're effective; they're working. That allows us, under the professional standards to really reduce the amount of work we're doing on the financial statement audit. And this is an area that I think over the past 10 years, you know, we've really taken a step

forward as a profession, really trying to make sure that we've integrated, you know, both of those activities and not think about them as two separate audits.

So after we think about, you know, internal controls, we then do think about what's the balance of the work we need to do to get comfortable with the financial statements and making sure that my financial statements are materially stated, are reasonably stated in all material respects.

Again, we think about the nature and timing, extent of the work we do. Based on the control comfort we get, we can certainly vary our plan substantive work and the evidence we need to obtain based on the effectiveness of the controls. And then we evaluate the overall results of the work, both from an internal controls standpoint, think about the reporting considerations related to those; we think about the results from a financial statement standpoint and the related reporting implications and move to, you know, opining on both the controls and the financial statements.

So obviously, at a very high level, the two points I wanted you to take from that is the two processes of auditing and signing the two opinions, one on the financial statements and two on the controls, are

very integrated at this point. And the level of work and the level of comfort you get on one certainly drives the level of work and comfort you get on the other. The other thing I would -- I would just add that I want you to take away is many of the things you need to do for an audit under 404(B) are similar, if not the same, to what you need to do under a financial statement audit. So making sure those work together in harmony is crucially important to making sure that we do, you know, both an effective as well as efficient audit.

So the last thing in my prepared remarks I'll just talk about is our perception of the key benefits of 404(B). You know, certainly what we hear in where we travel when we meet with investors, we hear that there's certainly value in a controls audit, in the transparency that provides around the effectiveness of controls. I think in this day and age, investors are asking for more transparency versus less transparency, certainly we see that with the PCAOB's proposed standard that's currently in front of the SEC regarding the new auditor reporting model and the fact that, you know, investors view that as being important to start to eliminate some of the information asymmetry that exists between, you know, auditors and management and investors.

We've certainly seen that over time, as

companies, as auditors become more familiar with how to audit internal controls, the costs have certainly come down and, importantly, I think the contributions of the SEC and the PCAOB in that area were important. From my perspective and from the firm's perspective, we certainly think that compared to, you know, pre-404, financial reporting is certainly more reliable than it was, certainly provides more accountability, both on behalf of management, as well as the auditor. From a, you know, data standpoint, the restatements of non-accelerated filers have always been higher than accelerated filers, so that is, you know, data that is out there to support the continued benefit of 404(B) audits and what that requires.

And we also notice that rates at which companies have ineffective ICFR continues to be, you know, noticeably higher for companies with smaller market cap versus larger market cap and the analysis that we've done using external data, it's typically, you know, twice as high when we think about that.

You know, obviously, there was also analysis and studies done by the SEC back in 2011 and GAO back in 2013, and those perspectives are similar to our perspectives and what we see. We've talked about the cost declining, investors' view generally that ICFR is

viewed as beneficial and the fact that financial reporting is more reliable when the auditors are actually involved in the assessment of ICFR. GAO found that companies exempt from 404 have more restatements, as we've talked about, and there are other benefits. In fact, you know, many of the companies interviewed in the GAO study said there was a lot of benefits, including ancillary benefits in the context of 404(B).

There's been a lot of studies done, academic studies done on the benefits of 404(B) and certainly not going to go through all of them, but one of the other benefits that some of the studies point out, and I just have one observation -- one study and one observation here, is companies that do have a 404(B) opinion that's issued by their auditor actually experience higher valuation premiums and as well as lower cost of debt. So there's a lot of academic research out there that also supports the fact that the benefits are certainly important.

So, you know, obviously, there's two sides to every coin. That's one perspective. We certainly do recognize that, as I said at the beginning, there's a cost associated with this. You know, I particularly have a level of understanding coming from the bio and pharma space that, you know, when you're precommercial, in

particular, and your focused on getting a drug to market, as I'm sure Bill will talk about, that, you know, having another incremental cost is just certainly something that needs to be carefully considered and we need to collectively be thoughtful, and I know that's what this Committee has been doing for a long time, so I will stop there. I'm certainly happy to answer any questions now. Yes?

MR. REARDON: And by way of comparison, it's no longer necessary to be -- that all public large companies are public. If I have a large corporation or business that is owned by a private equity firm but it's as big as many public companies, do those -- and it's an audit client of PwC, in most instances, will that engagement include an audit of internal controls?

MR. COMBS: To sign an opinion on internal controls?

MR. REARDON: Yes.

MR. COMBS: Often not, right? I mean I do believe, as you would expect, that was a portfolio company of a private equity company works up towards a potential IPO, that is when we would typically see more activity in that area and typically, you know, a private equity owner would often request that the auditor step in and start taking a perspective on the effectiveness of

the operating controls in preparation for them being public, however, you know, obviously without the data in front of me, we typically do not see people signing opinions on controls when they're private.

MR. REARDON: May I ask one other question?

MR. COMBS: Sure.

MR. REARDON: The exemption from the audit of the internal controls does not exempt the company from the duty to comply.

MR. COMBS: That's correct.

MR. REARDON: Is there an incremental staffing increase? I mean I go all the way back before Enron, so I remember when we didn't have all of this stuff, but if you were pre-Enron versus now, are you going to have a bigger accounting staff inside your company because of the internal controls requirements?

MR. COMBS: Again, I haven't done the analysis, right? But what I -- what I would tell you is, and it's company-by-company specific, right? I do think, from my perception, there is a greater focus on internal controls within a company now versus pre-Sarbanes Oxley.

MR. REARDON: No doubt about that, no.

MR. COMBS: Right. And I think with that, you know, there's probably incremental cost as well. As people, you know, test the controls in preparation for --

because obviously management has an obligation as well to assert to the effectiveness of controls, which it did not before --

MR. REARDON: Right, and the exemption, I assume Julie maybe you or Sebastian know, I assume the exemption doesn't extend to the quarterly certification by the CEO and the CFO or principle executive officer and principle accounting officer in SEC speak. They still have to make that quarterly certification, even if they're exempt from the internal control; is that right?

MR. GOMEZ ABERO: When we're talking about today, I think it's only the auditors as the stationed part of it.

MR. REARDON: Okay. So management's still on the hook.

MR. CLAYTON: So Steve and Sara, do you mind if I -- I just -- I think both Mike and I have engagements that we have to get to, but I'm going to try and come back, but I don't want to make a promise in that regard. I just want to say how important this topic is. It's been a long time since Sarbanes Oxley was adopted. It's been actually a long time since our first implementation with 404. I've asked many of the same questions that you just asked. I think a lot of -- a lot of good has come out of the efforts that we've made. We all know that,

you know, the bedrock of financial disclosure is GAAP financial statements.

I think we all know that to get to those, you have to have a good audit. To get to a good audit, you have to have good controls. But it's -- the devil is in the details and we should be exploring them. So I thank you very much. I don't know, Mike, if you want to say a few things.

COMMISSIONER PIWOWAR: I wholeheartedly agree. This is an extremely important topic. The cost and the benefits are -- I mean this is exactly the type of discussion we need to hear right now, so thank you all for coming and thank you for putting this on the agenda.

MR. VERRET: Just a quick question in reference to the 2013 GAO Study and the 2011 Chief Accountant Study, I read both of them very carefully, and I read the 2013 GAO study as actually kind of calling into question the findings of the 2011 Chief Accountant Study in a couple of ways. First of all, GAO took issue with the 2011 Chief Accountant Study finding a higher rate of restatement among exempt issuers, where they said, "No, the magnitude is higher," but on a pro rata basis, they're actually the same. And the graphs of how they change over time follow this same pattern.

And then the second point that GAO Study made very strongly, at least as I've read it, and you tell me what you think, is that most of the restatements that there were no statistically different pro rata differences in restatements, but to the extent there were, most of those were revision restatements, which the GAO described as not indicating some major problem with financials but were more minor. And I wonder what you think about that. And there's also the -- we should be talking, I think, about the '09 DERA Study for the SEC, which I think is also pretty enlightening on this discussion.

MR. COMBS: Yeah, so again, I pointed to two sources of information, right? I think what we typically see with our analysis, and when I do talk about restatements, I've -- you know, typically, we exclude the revisions, right, in that discussion, but what we've seen is a higher level of restatements between exempt and non-exempt companies.

MR. VERRET: And isn't it -- isn't it also the case that a majority of the time, findings of material weakness in internal controls under 404(B) failed to predict restatements? In other words, most restatements are not proceeded by finding of material weakness?

MR. COMBS: I think in a lot of -- you're

absolutely right. I mean and I do think that gets back to, you know, people being challenged in general, both management and auditors, around our material weakness, is it being called soon enough, right? So I do believe there's an element of that that still needs to be considered and addressed.

MR. YADLEY: Thank you very much. We appreciate you being here and sharing your knowledge. And as the Chairman said, the devil -- the devil is in the details and one of the ways you can see this happen is when a smaller public company changes auditors. They can be moving along, no problems, clean opinions, no issues, change auditors and, all of the sudden, there's all kinds of exceptions. And it's not that the old auditors weren't good and the new auditors are better, it's that this framework imposes a lot. And a fresh look is always good; it can certainly lead to improvements, but in many cases, it's a matter of you have the infrastructure and this sort of behemoth overall framework that causes you to rethink everything.

It's almost like when you change insurance companies and you're on a drug that really helps you and you've been through everything else and now the new insurance company says, "Well, we're not going to pay for this expensive drug. We want you to try all of these

other things." So I think that is a problem. I think the profession cares about its clients and understands that clients don't want to pay more than they need to pay. But this is an area where almost by its nature, it's expensive. And part of it is also the documentation, particularly smaller companies, as Patrick or you inquired, yeah, there's more staff just to keep up with the documentation that I think I some cases has benefit and some cases not. So I guess I'd like your views as to whether you see -- because I see out in the field that there's still a one size fits all mentality in this area.

MR. COMBS: Well, there's a lot there, right? I mean -- and I'll start with your first comment, and I don't think it's related to 404(B). And I don't think it's actually related to auditing or anything to do with the profession. When a new set of eyes looks at something with a different -- with different experiences, different training, et cetera, I think all of us collectively, you know, will bring a different perspective, so I think that's when you change -- your comment on changing auditors and having a different perspective raises, you know, things that we see as well. I'm not sure that that's solely related to 404(B). I mean I think we see that in a financial statement only

audit, right? So just to react to that.

I think in regards to, you know, documentation, there's certainly guidance that has been provided by the SEC in regards to what's expected. I think the SEC's view is not dissimilar to what the PCAOB's view is in regards to, you know, what's required under, you know, the assertion and the attestation regarding internal controls.

I will tell you there's a practical challenge from an audit standpoint in regards to understanding controls that are not documented. I don't think -- I think that the COSO framework and the work that COSO did on small business -- small entities really tried to get after that and say that in smaller businesses, you may not have the formality that you would have in a larger business for a number of reasons, right? They're smaller management teams, sometimes less sophisticated internal control structure that are more focused on, you know, a handful of people executing those controls on a day-to-day basis.

So I do certainly think that that's recognized in the guidance, but there is a practical challenge to that when an auditor who's not involved in the execution of the controls comes in and has to try to understand what may have happened, you know, two, four, six months

earlier and without that level of documentation, there's a practical challenge to that. So I do think that that's something that people try to look at and try to focus on and be as flexible as you can in the context of gathering corroborative evidence, but there's always a practical challenge to that and I think that's a fair point.

CO-CHAIR HANKS: Len, could I ask do you have any actual numbers, any data on the bills that are being presented to the companies? I was really interested by the comment that you made that sometimes when you bring on the 404(B) attestation, the pure audit cost goes down, which is kind of intriguing, but is there any source out there for the dollar number invoices that are being delivered to companies?

MR. COMBS: Well, I mean all of our audit fees are publicly available for public companies, if that's what you mean. So --

CO-CHAIR HANKS: Are they -- are they broken down? Is there an easy way of extracting that?

MR. COMBS: I think the question -- let me ask a question and then I'll respond. Are you asking is there a breakdown between the cost of the financial statement audit and the 404(B) audit?

CO-CHAIR HANKS: Yes.

MR. COMBS: There's not, right? As I said, one

of the important things we try to do is integrate the audit so where one starts and one begins -- where one ends and one begins is often difficult to ascertain. The better -- the better you do integrate the audit and given, as I said, many of the procedures you do under one are similar to the other, we typically would not break that down.

I will tell you one can sometimes look at that as when someone is not required -- when someone's exempt and then they go into, you know -- then they have to have a 404(B) audit. There's probably some information with that. I will tell you what's probably a little bit misleading about that, though, is as with most things, I think in the first year, there's often what I'll call a startup cost.

CO-CHAIR HANKS: Yeah.

MR. COMBS: Whether it's, you know, really working with management to understand what are those most important -- what are the most important controls and trying to determine that, assessing with management whether those controls are truly operating as they're designed. Once you get into that, often in cases, there will, particularly in the first and second year of a 404(B) audit be what I'll call remediation that management has to undertake to get their controls, you

know, at the right spot. So there are certainly startup costs that I would say are not recurring.

When we think about it, an integrated audit and the incremental costs, we typically think it's about 15 to 20 percent, approximately. Now, that being said, as I mentioned previously, the smaller the company, I think the more important that could be because I do believe, you know, there are elements of internal control that when you think about it, whether it's, you know, for example, the competency of the management team or the assessment of an IT system, that you frankly just can't spread a -- you don't get the economies of scale with a smaller company that you would with a larger company.

So I do think we think about that in the context of our portfolio as a whole versus, you know, there's probably a range of that, depending on the size of the company.

CO-CHAIR HANKS: All right. That was useful. So if anyone wanted to do to a study on this, the place to focus would be companies who have recently lost their exemption and how that changed both in the first couple of years and then maybe --

MR. COMBS: I think you'd have to look at it over a period of time and, again, I think -- I think there would have to be an analysis of smaller versus

larger companies because I do think there'll be a continuum of that.

CO-CHAIR HANKS: Thanks.

MR. VERRET: Just -- I just want to reference one point. There's a wealth of data, some of it funded by the PCAOB, to Chairman Doty) credit, he's been willing to fund stuff that's even critical of SOX and the PCAOB. One of the studies they fund is by Dorma Palla, looks at firms just above and below the threshold of $75 million and finds that firms manage their public flow just to avoid going past that threshold. They're willing to give up raising an average of $2 million in equity just to get below the threshold through, you know, buybacks or whatever. And he associates that with an expected at least one time cost from the transition of $4 to $6 million in compliance costs that they're trying to avoid, based on what they're willing to pay to avoid it.

So that's one attempt to kind of look just above and below the threshold.

CO-CHAIR HANKS: Maybe you could send a link to that around to the -- thank you. Anything else for Len?

MR. HINMAN: Len, do you -- sorry. Was there another question? It'd be interesting to know whether you have any observations around the evolution of sort of enterprise software and accounting software in this area.

I know there are a lot of products that have been introduced that make it a lot easier and cheaper for companies to not have to do so many manual adjustments where restatements are rife and to be more systems-based.

Is that an area where we're optimistic that cost may come down and/or compliance may go up?

MR. COMBS: You know, I do think that certainly what we've seen over the -- not just the last 10 or 15 years, but over 20, 25 years, right? That companies' use of technology has certainly grown and improved and to the extent that they're employing technology in a smart way, you know, the manual intervention override certainly diminishes. I mean I was having, you know, as an anecdote, I was having this conversation the other day about, you know, bank reconciliations, right?

And, you know, if you go back 20 years, there was often a lot of manual bank reconciliations that would have to happen because of the timing of certain things and now with, you know, the online environment that companies have and the treasury systems they have and the interaction with the bank on almost a real-time basis, you know, bank reconciliations don't take a long time now, right?

MR. HINMAN: But -- and do we see companies

sort of being driven to adopt more sophisticated systems as they prepare for a 404 audit or is that something you're recommending? Is that one of the incremental costs that we see that may have longer term benefits, but there's some front-ending to that?

MR. COMBS: Yeah, I do think that there is some front-ending of cost and I do think not just for 404(B) but in an effort, frankly, to become more efficient themselves to the extent that a company can implement, you know, automated repeatable controls versus manual controls that require a lot of human intervention. I think they're both more effective and efficient. Some companies choose to take that path and really try to drive the automation and standardization with the company. Others, for many reasons, including, you know, antiquated systems, et cetera, may not think there's a cost benefit analysis there, but we still certainly see, you know, as companies move towards 404(B) and they really start thinking about, you know, controls and the efficient operation of controls, there is a drive for more automation and standardization in what they do.

MS. YAMANAKA: So I have a clarification point on that. So when you were speaking and, by the way, I'm ex-PwC, so my thoughts are always with you guys and I totally get that side of it.

MR. COMBS: Right.

MS. YAMANAKA: But now I'm on the other side of operations. And so if we're looking at the total number of accounting structure, financial accounting structure support resources that are in an organization and we're saying now, the last 20 years, 10 years particularly, ERP is driven all the way down to the smallest companies, and by definition, nobody should be doing the manual bank rec anymore, so you have less people doing those manual jobs, but the incremental cost is probably higher in the control area, right?

So if we were looking at things in total incremental cost doesn't look that high from a maybe external cost or in internal resources, but in reality, if we look at who's doing what now, less people doing bank recs transaction work, more high-powered work in terms of controls, analysis, et cetera, but the real cost for that is probably buried within the internal operation of the company and we can't look at it on an incremental basis. Do you think that's a fair analysis or --

MR. COMBS: Obviously, a very complex question because you're talking about an evolution of technology and controls over, you know, many, many years and to make a blanket statement about, you know, companies at large would be very, very difficult. I do think what we've

seen is over many years, not just as a result of 404(B), but you know, companies have automated what they do, third parties that they interact with have automated what they've done and accordingly, in everything we've seen, technology has certainly driven down the cost of doing things, right, and made things more efficient and more effective. That being said, I do think there's a cost of 404(B) that's internal as obviously as well as external. And a lot of it, the internal costs are around management checking that the controls are working effectively.

Now, to the extent that those are automated controls, it's much easier to check and validate than it is a manual control. But, you know, I do think that there's an element of compliance cost that is incurred internally by the need to assert to the effectiveness of controls.

MS. YAMANAKA: Thank you. And just to collaborate with what you were saying regarding those costs, I think that from my experience, I see, you know, when people are looking at getting audited for whatever reason, that anticipation of audit changes behaviors, right, at whatever level you are.

MR. COMBS: Which could be a good or a bad thing, right? It's both.

MS. YAMANAKA: And -- well, in my opinion, usually it's a good thing.

MR. COMBS: Right.

MS. YAMANAKA: It makes my job easier definitely. But I think that's one thing that we have not explored here is what is the kind of like threat implication of changing people's behaviors in their getting ready for whatever activity they have or preventing their activity from moving forward, so thank you.

CO-CHAIR HANKS: Thank you. We will move on to Bill.

MR. NEWELL: Thank you very much. I have some slides that'll be up here in a second, but let me say first of all, it's my privilege to be here. As a former corporate securities lawyer who advised clients on auditing -- related to auditing financial statements and other matters, it's an area that I have a fair amount of familiarity. And also, as a leader in a number of smaller public biotech companies, you know, I think back to a lot of changes that we had to address as a management team in the way we presented our financial information.

And now as a leader of a small privately held biotech company trying to make a difference in cancer

looking forward, I hope, to a public offering next year, thinking about the changes that we're going to go through as a public company and then thinking about the changes as a small reporting company that we're going to anticipate, I always like to look ahead and understand what's going to be required of us so that we can be prepared to meet our obligations. So 404(B), I think has been in the main helpful, but for the smaller companies, and that's the group that I want to address with you today, and particularly those in my industry, the biotech industry, we think it's overly burdensome and we would appreciate some additional flexibility beyond what exists in the statute today.

I am going to recommend that companies be exempted where their public float is less than $250 million and also, I would recommend that if you have annual revenues that are less than $100 million, you also have an exemption that continues as well. And the $100 million revenue number is, I think, it may be a new one for your consideration, but it's one that we think is appropriate given the cost and the burden of going through the 404(B) attestation and examination.

Len outlined that companies have to have an external audit of their internal controls. What I want to emphasize, however, is that companies, whether they

had an audit or not, still have an obligation to have internal controls and management is required to attest to their effectiveness. So what we're talking about today are the benefits of an audit. It's not that companies don't do it, and it's not that we don't take them seriously and attest to them, it's a question of what is the cost benefit of the audit. And for the smaller public companies, I would tell you that I think the cost benefit is not where it should be.

So let's start with a look at which companies have to have a 404(B) audit. And there are two categories of companies. If you are a non-accelerated filer, you have a public float below $75 million and you have an exemption from 404(B) as long as you remain in that category. As an aside, according to the Securities and Exchange Commission, these companies currently make up just .01 percent of the total public float on the market. So we're talking about a really small share of investor value that falls within the category of a non-accelerated filer.

As Len alluded to, emerging growth companies, which is a term that was created in the Jobs Act, have a five-year on-ramp to 404(B), and this is the standard of what an emerging growth company is. At the end of that five-year period, they go back into a normal

categorization, and that means that if you are above $75 million, you now have to have an audit of your internal controls.

The Advisory Committee endorsed increasing the public float limit for non-accelerated filers to $250 million in 2015, and I believe the SEC should enact that reform. This April marked the 5th anniversary of the Jobs Act, so we're starting to see companies roll off their 404 (B) exemption and these companies are still many years away from product revenue.

As a consequence, and as I will document for you, a number of companies will be diverting funds from scientific research and clinical development to compliance costs to anticipate the 404 (B) audit; 229 companies have gone public -- biotech companies have gone public under the Jobs Act. Virtually all of these companies have a public float above $75 million, despite the fact that the average company has fewer than 100 employees and no product revenue.

The companies are given credit in the marketplace by virtue of the fact that they are making important new medicines that investors believe will have a financial return for them. But they do not yet have a financial return available to them. And it will be many years before many of these companies ever see product

revenue. You can see on the slide that I've put up the impact that the five-year period will have in the coming years. We now have eight companies that went public in 2012 that are rolling off their exemption this year, and there are going to be dramatic increases in 2013 and in -- - for 2013 and 2014 publicly floated companies.

The 80 biotech IPOs in 2014 represent the single largest year for IPOs and in 2019, just a little over a year-and-a-half from now, they will all face the cost burden of 404(B) compliance, so this is a very timely conversation for us to be having. The impact on the biotech companies that I am speaking about is significant. We see increases in cost attributable to 404(B) that can be anywhere from $300,000 to $600,000 when you combine the incremental audit fees, external consultants and internal costs. So that gives you a range based on the companies that we've talked to. And I will give you some specifics here in a minute.

To put this in perspective, a typical biotech company would spend that amount of money on three to six research scientists for a year, who are working to deliver new medicines, whether it is for cancer, Alzheimer's or other indications that we as an industry are pursuing. The absence of having those three to six researchers delays our research and impacts adversely our

ability to discover and develop new medicines.

The costs, by the way, we don't believe are decreasing, in the main, they seem to be increasing as the PCAOB has increased pressure on audit firms. Anecdotally, I will tell you that while I think it's fair that people do try to scale the audit reviews of controls, in fairness, the PCAOB wants to have high standards for all auditors and as a consequence, I think many of the small companies feel like they're being treated as if they were Pfizer.

I reached out to several colleagues in our industry and they all told me a similar story about the cost burden of 404(B) and the value -- lack of value it creates for investors. So I'm going to talk about a couple of companies here on the next slide. In Example A that I have put up, this company went public before the Jobs Act and did not benefit from the five-year Jobs Act exemption. They estimate that their costs for 404(B) audit are north of $400,000. And it's worth remembering that this is an annual incremental cost to the company. The company has a public float of around $2 million, but they are still prerevenue and have just 60 employees. Some detail, their costs included $250,000 paid to their auditor just for the 404(B) audit. Their full audit fee was $450,000, so that gives you an example of what the

cost differential is; $150,000 for internal labor and another $40,000 for additional consultants.

Example B is another company that went public before the Jobs Act as well. Their public float, $560 million, would've qualified them as an emerging growth company had they gone public under the Jobs Act; $240,000 of their audit fee was attributable to 404(B), plus an additional $105,000 in internal costs and $30,000 to outside vendors, all of which aggregates to $375,000 per year. This company has 80 employees; half of them are PhDs. And the spend of nearly $400,000 on the audit is just not a good use of their capital.

The reason that this is such a damaging diversion of capital is because all of this does not provide any meaningful protection or useful information to investors. As I said, companies are still required to maintain and attest to internal controls, regardless of whether they are 404(B) compliant and investors really do not gain, I believe, any meaningful information from the incremental cost.

Biotech investors, in particular, look to a company's science. They look to the product opportunities that the company is developing. They look to the clinical pathway that the company is pursuing, and they keep an eye mostly on the company's cash and cash

burn. Those are the two things that biotech companies want investors to pay attention to because those are the most relevant to the company's ability to actually earn investors value from an increase in the stock. Because without cash, we are not making new medicines. And without the promise of new medicines, the company's value will not rise.

We've talked to many of the companies in preparation of this hearing, and uniformly, no one has ever had an investor conversation about 404(B) and whether their controls are properly in place as a result of an audit. It's just not something that investors care about for biotech companies because it's not relevant to their investment decision.

You know, we've now had almost five years -- have had five years of exemptions for these no-accelerated filers and I'm not certain that we see any harm for the people who have been in the emerging growth company sector to their financial statements as a result of not being compliant under 404(B). I just don't think we have the luxury to do the sort of financial engineering that an Enron or a WorldCom was able to do. We put our money to work for science and we don't have time to play games with it. And, as I said, in the main, we can't manipulate our cash balances. Those are what

they are, and our burn rates are what they are. Those are the things that investors care about.

So let me add a couple more real world examples that are about to occur to companies that are going to be losing their exemption. So Example C, Company C here did their IPO in 2012. They will lose their exemption this year. And they are learning firsthand the difficulty of 404 (B) compliance. The CFO I spoke with described a conversation with his auditor where they projected a 100 percent increase in his audit fees due to 1,000 additional man hours necessary to complete the 404 (B) audit. That increase will cost the company $250,000. Other additional costs include an increased fee to their consulting firm of $60,000, a new part-time consultant specifically to manage the day-to-day of the audit at $50,000, plus other internal costs not yet quantified.

For context, this company has 60 employees and it has a public float of $85 million. And this single compliance exercise will increase their annual burn rate by 1 percent, just to do that. Example D is a 2014 IPO company that still has a couple of years left on its 404(B) exemption, but they've already started to prepare for compliance. Their $240 million public float will put them outside the non-accelerated filer definition as it currently stands and they, as well as the Company C, are

exactly the sort of sub $250 million company that would benefit from the changes that I'm proposing.

Already, as they think about the costs of compliance, they estimate a significant increase in their audit fee of about $325,000 and a total increase cost of about $500,000. Other Jobs Act companies that we spoke to anticipate their exemptions expiring in the next few years and they believe they will incur somewhere between $150,000 to $350,000 in additional audit fees, $50,000 to $150,000 in other consulting costs and either $40,000 or as much as $200,000 for internal labor. In some cases, these companies are planning to hire an FTE for the finance team instead of hiring a scientist, which is a real shame.

I have heard, and Len alluded to, that 404(B) audit can improve the debt financing rates that we might get. Well, I will tell you that we just raised $15 million in debt financing and we would have to lower our interest rate that we pay on that debt financing by 1 percent to pay $400,000 of audit costs, were we to get there, and that would just be for one year. I don't think we will ever get a cheaper debt financing vehicle if we were compliant with 404(B).

Fortunately, the SEC is considering reforming the public float threshold of $75 million. Last summer,

the SEC followed the Advisory Committee's recommendation to amend the smaller reporting company definition by increasing that public float from $75 million to $250 million. However, the SEC did not propose a corresponding reform to the non-accelerated filer definition, which the Advisory Committee had recommended.

An increased small reporting company definition would allow growing companies certain scale disclosure requirements on their quarterly and annual filings, but the big ticket cost driver of 404(B) is governed by the non-accelerated filer definition, not the small reporting company definition. Fortunately, the SEC did solicit comment and that's one of the reasons that we're here today. Numerous organizations filed comment letters endorsing a change in the non-accelerated filer definition and its associated 404(B) exemption.

The comment letters echoed a proposal put forth by the SEC's Small Business Forum for the last eight years to amend both the small reporting company and the non-accelerated filer definition to include companies with a public float below $250 million or revenue below $100 million. Supporters included innovation industries like the biopharmaceutical and medical device industries, economic drivers like community bankers, advanced

manufacturers, the venture capital industry and both of the major national securities exchanges.

The public float test of $250 million would harmonize the small reporting company definition with the non-accelerated filer definition as well. They're already thought of interchangeably by many market participants and we believe that the same standards should apply to both tests. The revenue test that I speak of, $100 million, would be a new addition to both of those definitions, and I think it's an important one. Public float ultimately recommends investors predictions about the future of the company, but it doesn't reveal much about the company's present ability to pay for expensive compliance burdens like 404(B).

The current non-accelerated filer definition allows a company to use a revenue test if it cannot calculate its public float. That test is set at $50 million in revenue, but commenters on the SEC's proposal supported a stand-alone revenue test irrespective of public float. The small business -- the SEC Small Business Forum made the same proposal. Companies would be able to qualify as a non-accelerated filer and a small reporting company if their revenues are less than $100 million annually.

Ultimately, I would argue that revenue is a

more appropriate arbiter of a -- than company size -- an important arbiter of company's ability to pay than public float. So I'm hopeful that the SEC will consider a revenue test in addition to the public threshold test.

Two final points that are worthy of consideration. The first is we are not talking about a large universe of companies with a tremendously big market cap. The SEC calculated last summer that increasing the public float test to $250 million would allow companies representing .02 percent of total public float on the market to qualify for that exemption.

Obviously, this is a small investor risk in terms of the overall market. Second, and more importantly, lack of investor and issuer desire for this requirement does exist. Now, if the fact of the matter is that these sorts of audits would drive investors to our companies, reduce our costs of capital, companies would be not taking advantage of the exemption, they would be having the audits done, and that speaks volumes that they're not doing that. So by making compliance optional for a broader range of growing companies, you preserve valuable funds for innovation and preserve the option for the companies and their investors to opt in if they feel that it's necessary. I think the fact that they're not opting in tells you that they don't feel that

it's necessary.

I hope you all will follow on your proposal from last summer and bring the non-accelerated filer definition into line with the proposed small reporting company definition. Thank you very much for your time.

CO-CHAIR HANKS: Questions? Patrick first.

MR. REARDON: Yeah, I'm the obsessive compulsive one who's always got a question. Is it Dr. Newell or Mr. Newell?

MR. NEWELL: No, you can call me mister. Thank you.

MR. REARDON: Why bother going public?

MR. NEWELL: (Laughter) It's a really good question. When you think about the cost of the developing a new medicine and you think about the capital that's available to you as a private company, you can stretch that capital to a certain point in time, but then you get a point, get to a point where you need the greater resources that are available from a public market environment. Our company, which was founded in 2003 and has been fortunate, we've raised $100 million in venture capital. We've raised another $200 million in non-dilutive revenue through partnerships. So that's $300 million. And we're just about now, at the end of this year, to file our first investigational new drug

application with the FDA to put our first drug in the clinic.

We'll put two more in the clinic beyond that in the next 12 months. And that's an incredible cost. That's going to cost us $60 to $100 million over the next two years for clinical development costs. The private venture capital markets will not support that and so we will consider, if the markets look favorably on us, going public because it gives us access to a larger pool of capital and we know that there are costs associated with that access. And we don't mind the cost as long as the costs are relatively important for investor protection. Where they're not important for investor protection, we view those costs as a waste of money.

MR. REARDON: This might not be a fair question, but -- and it may not be one you should answer, but what do you estimate your cost of preparing a registration statement and getting it to be effective as far as SEC compliance goes, I mean just the whole thing, not just the audit.

MR. NEWELL: Understood.

MR. REARDON: And your annual compliance costs, what do you estimate those to be? Are you budgeting?

MR. NEWELL: Yeah, the first one is easier for me to answer because we've already done that analysis.

It's going to be about $3 million.

MR. REARDON: $3 million and you're not making any money.

MR. NEWELL: Yeah. No. No, sir. The other, I will be talking to my CFO in the next month about as to what our ongoing costs are going to be as we do our 2018 budget.

MR. REARDON: Would you say I was out of the ball park if I just took a wag and said $1 to $2 million?

MR. NEWELL: I wouldn't dispute that.

MR. REARDON: Thank you.

MR. VERRET: Not to sound like the resident academic, but I wanted to throw out for the record and for the Committee's consideration, and also to the extent DERA is going to need to buttress corp fin's work on this. A couple points of evidence consistent with what you've been talking about here in critiques of 404(B), so Professor Lobo in Journal of Accounting Auditing Research finds that when you control for the benefits -- and Patrick's alluded to this, when you control for the benefits of 302 and 44A, it's hard to find any benefit in 404(B). And a lot of the studies that find a benefit here lump them all together, and that's a huge mistake.

So controlling for that, 302, 44A, pretty good at limiting stock price volatility, 404(B) is not. One

of the leading critiques to be the most important thing for us to think about, Rice & Webber, Journal of Accounting Research 2012 finds that a majority of the time for findings of material weakness under 44B, do not proceed material restatements in the financial statements. So in one year that they studied, 84 percent of misstatements -- of restatements were not proceeded by a finding of internal control weakness during the period of the restatement.

The 404(B) audits failed 84 percent of the time that year. I mean there's just -- to me, that's very powerful evidence of reconsideration of the cost of 404(B), not just in the small firm context but across the board. And, you know, I would suggest that even beyond our jurisdiction, a reconsideration of the cost of 404(B). So just wanted to through that out there for your consideration.

MR. NEWELL: Thank you very much. That doesn't surprise me a tall. And, as a matter of fact, when a small public company like a biotech has a restatement, I don't know that investors really care that much about it, as long as their cash balance is still what it was the day before the restatement. We don't look to financial metrics for public biotech companies. Industries don't look to financial metrics to public biotech companies the

same way they look to metrics for revenue producing companies. What investors are looking at is what is the future potential of the drugs that you're working on to develop and how does that translate into a return on their investment? That's what they care about. And they care about how much capital you have available to actually deliver on the promise of your new therapies.

CO-CHAIR HANKS: Greg, go ahead.

MR. YADLEY: I was going to say I sat next to J.W. and wore the same suit so that I can piggyback on his data.

MR. VERRET: Really good, different tie.

MR. YADLEY: Thank you very much, Bill. This is back to you Len because I think you've both reminded everyone that an audit of the financial statements doesn't include, by its very nature, some review of internal controls, and also under 404A, that management is making an assertion under penalty of perjury of certification as to internal controls. How do you believe the profession is doing in terms of giving credit for two things in the internal control area? First, the tone at the top, which is extremely important from a governance perspective and particularly in smaller companies with fewer employees, it really matters who the CEO is and how involved the board is and what the tone of

the top is.

And then the other area is internal audit, where a company has a person or a function separate from operations that is looking at this area. How do they get credit with respect to internal controls reviews for small companies?

MR. COMBS: So the second one is a lot easier. What I would say, and Bill can probably share his experiences as well, is many of the types of companies that Bill is talking about would not have internal audit functions, so often it's difficult for us to kind of leverage that work. To the extent that a company does have an internal audit department, we are very much able to and do significantly leverage the work that internal audit does over their assessment of internal controls. And that's one of the changes that when I talked about changes in 2007, that was one of the important changes that allowed us to even increase the level of reliance on internal audit. And so I do think that there is a huge opportunity to do that. And I do think broadly speaking, you know, auditors do that. I think often, however, the size of companies we're talking about and Bill's talking about, you know, not dissimilar to having an external consultant, often the external consultants they're talking about are serving a quasi-role of internal audit.

So it's a similar concept that they don't have the ability or would rather spend their money in a different way versus hiring internal audits. So often, that's the case. I mean is that --

MR. YADLEY: Yeah, no, there -- I don't know of any small biotech company that's public that has an internal audit function. It just doesn't exist.

MR. NEWELL: Yeah, that would -- that would be for operating companies.

MR. COMBS: Yeah, in regards to your -- to your first question, tone at the top, I mean as you say, it's hugely important, tone at the top, particularly when you think about, you know, fraud considerations and how you think about that. I do think, at some level, given auditors have the ability to assess risk and determining the nature/timing/extent of their work, to the extent that they believe there's not good tone at the top or that's been questioned in the past, I do think that drives, you know, incremental work, meaning you may need to test a control, but if you're not comfortable with the tone that management's setting, which includes hiring competent people and other things, I certainly think that would drive, you know, the level of work you need to -- the number of times when you do the testing of those controls. But it's certainly less directed. I mean tone

at the top is not a direct control.

MR. HAHN: I'd just like to add to some of your comments here. We represent -- we're actually one of those 80 biotech companies that went public in 2014 that about a year-and-a-half, two years from now, we will be 404(b) compliant. We will still be prerevenue. Again, I won't go through all of the details because I can support all of those numbers, but we're looking at about $500,000 of increased costs. I think it's important to kind of drill down a little bit and give a little bit more detail, though, that 99 percent of our assets on our balance sheet are still cash.

We have 42 employees. We cut 125 checks a month. And the CEO and are are still the only two check signers. So, you know, since we've been public, we've had say 500 investor meetings, same thing. What's your cash balance? How far will it get you? Where is the data? I do also want to add, though, that I think the revenue test is important because right now, we're over the $250 public float. Our current market cap is close to $400 million. So the revenue test would be important for companies. I know there's several hundred companies that are in the same boat as we are. But I'd also like to add though that, you know, we are, you know, 404(a), so the CEO and I have to sign our name on the line, and

we do spend right now about $25,000 outside for a third party that reports directly to our audit Committee.

So there is some comfort from the audit Committee towards our internal controls, so I do think there is a scalable solution here to get away from the one size fits all.

CHAIRWOMAN BANKS: On the subject of one size fits all, is there any reason -- I know you talked about the $100 million revenue test. Any reason why that wouldn't be equally applicable to non-bio companies? Is there any distinction between non-bio companies and others who are pre-revenue?

MR. NEWELL: Yeah, I think that --

-- a good question. I'm not advocating for it only for biotech companies. I think the lion's share of public companies, though, that are going to be above $250 million are most likely going to be biotech companies. That's just the nature.

We have investors who are investing in the promise of our therapies. Most investors invest in the product that's on the market and the sales trajectory and -- and that sort of thing. So I don't know that there's any particular logic that says a non-biotech company that meets the threshold shouldn't get the same -- shouldn't get the same treatment. It all comes down to what --

what's a reasonable financial burden for a company to undertake and what's the investor benefit for that financial burden.

And, you know, when you're under $100 million in revenue, you're -- particularly as a biotech company, and Brian knows this well -- you look at every expense and have to justify it to yourself because what we're trying to do is something that's pretty darn difficult. That is, understand human biology and intervene in it in a way that can be life-saving. So we look very carefully at expenditures to justify them.

MR. COMBS: If I could just add to that. I mean, hopefully, you know, I tried to present a balanced view, but I do think that -- that when you look at this, and to what Bill said and what Brian said, I think you need to look at the risk related to the company, and the risk that exists at a, you know, pre-commercial company are different and usually not very -- not nearly as complex as they are at a commercial company. Right?

And so, you know, the benefit, in fact, you know, may be less at a pre-commercial company and how you spend your money is important, and if -- if -- you know, I think Bill is fair, because I come from this industry as well. Investors are looking at what the -- what the future value of the pipeline is and the products and the

fact that they are looking at cash burn. That presents a much different risk profile for a company than a -- than, you know, like a biotech company that has launched commercial product and is dealing with the challenges of revenue recognition and the complex payer system that exists in the U.S., as et cetera.

So I do think it's important, and I certainly -- - I 100 percent say that it really needs to think about the risk that's presented by a company.

CO-CHAIR HANKS: Anybody else?

MR. REARDON: I have one. It's not a question but an observation. We've had presentations in the past on the declining number of public companies, and to state the obvious, I think this is -- this kind of cost -- and this is not the only cost that's like this yet, all the silliness that goes on in proxy solicitations. You have Congress's issue de jure that needs disclosure. All of this is just -- adds up and at some point, if you're not in Mr. Newell's company's situation and you've got a choice and you vote with your feet and you say, "I don't need to put my head in that lion's mouth," and you go and you become a private company.

So Mr. Hinman, in a way, you're in a competitive market and you've got -- you're competing to keep these companies public or to make them go public,

and there are a lot of market forces out there that are -- - are pulling the other way. Now, God knows you've got more people pulling you in different directions, and I don't envy your job. But I mean that is -- at the end of the day, there are market forces that are going to drive companies, like promising companies like Mr. Newell's -- if not this particular company, other ones -- to be private or to thumb their nose at being public and just leave.

MR. HINMAN: Totally understand that, and we also understand that the biotech, sir, is one of the few sectors where the public markets still are attractive enough that they're going to, you know, bear the burdens. But totally appreciate that we're putting a lot of straw's on the camel's back, and it's not so much fun to be a camel anymore.

MR. REARDON: No, and --

(Laughter.)

MR. HINMAN: And we're very cognizant of that and we are prioritizing --

MR. REARDON: We're trying to be good camel drivers.

(Laughter.)

MR. HINMAN: We are trying to prioritize things that make it a little bit more attractive. You know,

there's an assortment of issues that we all recognize. It's not just the regulatory burden that have sort of changed the landscape on who's going public and when, and the attractiveness, relative attractiveness of that versus private capital. But we get it, and you'll see in our rulemaking agenda and the priorities that we are -- we're focused on the -- on the topic.

MR. REARDON: Thank you.

CO-CHAIR HANKS: Any more questions for our experts? Well, thank you very much. It's been very useful. Thank you.

MR. NEWELL: Thank you so much for your time and attention today.

MR. COMBS: Thanks.

CO-CHAIR GRAHAM: Okay. The next thing on our agenda is the final report of this committee. The first iteration of this advisory committee was established by the SEC in 2011, and the committee has been renewed for a total of three two-year terms. Back in 2011, small businesses had fewer options for raising capital. If a company wanted to conduct a widespread offering of securities using general solicitation, frequently it would have to go public and register the offering with the commission. Businesses not needing to engage in a general solicitation most commonly would have conducted

an offering under Rule 506(b), which, as I think most of us know, is (inaudible) 506.

We seem to be leaving some -- losing some folks. Is -- was there --

CO-CHAIR HANKS: They just need coffee.

CO-CHAIR GRAHAM: They just need coffee. Okay. Then they're going to need a bio break, but --

(Laughter.)

CO-CHAIR GRAHAM: 506(b), which limits purchasers who are accredited investors to no more than 35 sophisticated investors. This meant there were limited options for businesses that were not ready to conduct a registered offering and did not have access to accredited or sophisticated investors.

Since 2011, however, legislative changes and SEC rulemakings have led to significant changes. The exempt offering framework has been expanded to allow new capital-raising avenues for small businesses and updated to reflect the realities of life in the internet age. The recommendations put forward by the advisory committee over the past six years played a role in many of the changes leading to the current framework.

In December 2016, Congress added a provision to the Securities Exchange Act that establishes in statute a similar advisory committee on a permanent basis, the SEC

Small Business Capital Formation Advisory Committee. We have drafted a final report to memorialize the 17 recommendations made by the committee and to identify areas we recommend for continued focus of the commission, the SEC staff and the future Small Business Capital Formation Advisory Committee.

I think all of you have had an opportunity to review the draft report that was circulated. I'd like to take your comments now. As everyone should know, one of our members, namely Patrick, has submitted a set of comments in writing. Does -- did everyone receive a copy? Did everyone receive copies of both documents?

(No response.)

CO-CHAIR GRAHAM: Okay. Open to suggestion, but I think that what might make some sense is if we just page through the report. And I would suggest that we use the mark-up that Patrick supplied, (inaudible) make all of our lives easier as we kind of go along.

Okay. So we start out with the history of the committee. We list the recommendations, and I think if we get to some comments on page 6. Does anyone have any comments before page 6?

(No response.)

CO-CHAIR GRAHAM: Okay. First -- first comment is the addition of the lead-in paragraph to part three of

-- I am disinclined to include this for two reasons. I don't think -- you know, I don't think we need it, and I haven't read it. So if -- anyone else have any viewpoint on that?

(No response.)

CO-CHAIR HANKS: I guess they haven't read it either.

CO-CHAIR GRAHAM: Okay. Unless -- unless I hear any objection, let's -- let's not include that. I think the addition of the word "the" further down and deleting "a" I think is fine. No disagreement there?

(No response.)

CO-CHAIR GRAHAM: That gets us to page 7. Any comments?

(No response.)

CO-CHAIR GRAHAM: What about page 8?

(No response.)

CO-CHAIR GRAHAM: Nine?

MR. YADLEY: Steve?

CO-CHAIR GRAHAM: Yes.

MR. YADLEY: So sort of the carryover from page 9 -- and first of all, thank you very much for taking the care you did with Sara to draft this report. It made it a lot easier for us. I was making notes in advance of the meeting, and you did a terrific job of capturing what

we talked about and one of the points --
CO-CHAIR HANKS: Actually, the staff did a brilliant job (inaudible).
MR. YADLEY: And the staff did a brilliant job.
CO-CHAIR GRAHAM: I was going to say we, in turn, thank Julie and Sebastian, but --
MR. YADLEY: I was -- I was -- that was my -- that was my handoff.
(Laughter.)
MR. YADLEY: So one of the things that was noted was that we did not have a mandate, as did the earlier Small Business Committee, to actually create a report, and that was our focus. We had specific things to do. And I think our being unharnessed has led to a really robust series of discussions, and it's important that we now do a report because it is a little bit humbling to see all the things we talked about. Some of the things that made their way into the JOBS Act were presaged by what we did working with the staff.
It almost reminds me of Sarbanes-Oxley, where, had the times been different, I think the SEC would have -- would have implemented most of the things that Congress told them to do and would have done a better job. And certainly there are parts of the JOBS Act that we commented on, including crowdfunding, where I think

the expertise and continuity of the staff and input from informed folks like us might have led to a better result. But in any event, thanks, Sebastian and Julie and Betsey and everyone for that.
But to page 9 and the carryover on page 10, I do have some wording suggestions --
CO-CHAIR GRAHAM: Yes.
MR. YADLEY: -- if that's okay. I -- unfortunately, Irma unbundled me from my computer and I was untethered and didn't have access to this until yesterday. But at the top of page 10, "undertaking small transactions which make them unattractive to registered brokers;" and (b), I would leave (b) the way it was initially and delete "and the complexities" and so on. And then after the word "broker," and a period would include the following: "We further believe that the data is misleading," or we could say that "the numbers are understated due to," and then pick up "widespread noncompliance by those who should be registered."
And then before the last sentence that Patrick added, I would say, "Therefore, we believe there is" -- my own writing. Let me come back to that. But the first part, and it's in my scribble, but I can write it down, but it --
CO-CHAIR GRAHAM: Okay.

MR. YADLEY: I don't know if you got that, or Julie, you (inaudible) understood --
CO-CHAIR GRAHAM: Okay, thank you for that. The last sentence that was added, also (inaudible), et cetera, I'm not sure if I agree with that. And this -- this whole portion of this paragraph basically relates to the fact that only 13 percent of Reg D offerings reported using a financial intermediary, and I'm -- I don't think that this last sentence has anything to do with that.
CO-CHAIR HANKS: But I think it's also a judgment that this committee didn't actually make at the time we discussed it, so I would leave it out for that reason.
CO-CHAIR GRAHAM: Any disagreement?
MR. REARDON: I obviously put it in there because I think it's a factually correct statement, but I will defer to your judgment. It's not something I'm going to beat my chest over.
CO-CHAIR GRAHAM: Fair enough. Thank you. Footnote 19, I -- typically we don't include individual -- or the views of individual members, so I wouldn't have that -- I would not include that footnote.
Page 11? Yeah.
MR. YADLEY: Just the very top, the ACSEC. I would include the word "first" after that. Just a small

suggestion.
CO-CHAIR GRAHAM: "First made recommendations"?
MR. YADLEY: Yeah.
CO-CHAIR GRAHAM: The new language, the added language in the next paragraph, I'm fine with that. Does anyone have a different view?
MR. YADLEY: Just capitalize "committee" in that if we include it.
CO-CHAIR GRAHAM: Got it.
MR. YADLEY: Footnote 25.
CO-CHAIR GRAHAM: Mm-hmm.
MR. YADLEY: The second sentence, "This letter addresses persons assisting in the transfer in control of smaller businesses as M&A brokers but does not provide any relief for capital raising by such companies." In other words, I think the footnote is good to point out that the division did provide very helpful action here, but it's not in the context of capital raising. So the letter addresses persons assisting in the transfer of control of smaller businesses as M&A brokers but does not provide any relief for capital raising by smaller public companies.
CO-CHAIR GRAHAM: Right. Got that, Julie?
MS. DAVIS: It would say, "This letter addresses persons assisting in the transfer and control"?

MR. YADLEY: "Transfer of control."
MS. DAVIS: "Transfer of control."
MR. YADLEY: "Of smaller businesses."
MS. DAVIS: Okay. Thank you. And then after M&A brokers, "but does not provide any relief for" --
MR. YADLEY: "Capital raising."
MS. DAVIS: -- "capital raising by smaller companies"?
MR. YADLEY: Yeah.
CO-CHAIR GRAHAM: Okay. That takes us to page 12. I wouldn't designate us here as the outgoing committee. We're just the committee (inaudible), so we'll continue with that.
Thirteen?
MS. TIERNEY: I'm sorry, if we could just go back to the accredited investor section. I think it might be helpful -- I don't have specific wording, but just a concept. You know, one of the things that we spoke about with Chair White was this potential concept that there should be investment limitations put on top of accredited investors if the definition was expanded, and I think we felt that that was the wrong way to go. I wouldn't mind seeing some language in here that highlighted the fact that we'd like to see the definition expanded without any limits put on the actual amount

people can invest, because I think that that's counter --
CO-CHAIR GRAHAM: Okay, let's see. Which -- what page are you on, Annemarie?
MS. TIERNEY: Twelve, in the paragraph --
CO-CHAIR GRAHAM: (Inaudible) 11?
MS. TIERNEY: -- that says we support the expansion of the definition to take into account measures of sophistication. Maybe in that paragraph just add some language that, you know, we did not support the idea of limiting the investment -- halving the investments available to be made by people in the expanded categories.
CO-CHAIR GRAHAM: I don't disagree with that, but I'm still looking for what you are suggesting that we add in.
MS. TIERNEY: In the "our committee" paragraph, the outgoing (inaudible), supports the expansion -- "expanding the definition to take into account measures of sophistication." It's the second full paragraph on page 12.
CO-CHAIR GRAHAM: Yeah. Oh, so you kind of tricked me. You're right where we were.
MS. TIERNEY: That's right.
(Laughter.)
CO-CHAIR GRAHAM: Okay.

MS. TIERNEY: And I wasn't trying --
CO-CHAIR GRAHAM: I thought you were actually going back. Okay. It's okay. Got it.
MS. TIERNEY: No, no, no. I wasn't trying to trick you. You said page 13 and I said no, hold on.
(Laughter.)
CO-CHAIR GRAHAM: Thank you for --
MS. TIERNEY: I'm being very transparent.
CO-CHAIR GRAHAM: Thank you for your help, Annemarie.
MS. TIERNEY: You're very welcome, sir. Happy to help.
(Laughter.)
CO-CHAIR GRAHAM: Okay. Did you get that, Julie?
MS. DAVIS: Got a concept, no words.
MS. TIERNEY: Actually, I can -- I'll send you a sentence I was circulating.
CO-CHAIR GRAHAM: Okay.
MS. DAVIS: Great.
CO-CHAIR GRAHAM: So, page 13? I think the changes are okay. And 14, a -- I'm disinclined to add the new language. I recall noting this in April. Anybody else?
MR. VERRET: I support the language, although I

would strike -- I would -- my suggestion would be to strike the word "psychometric", and I say all that knowing that I wasn't there and I'm a new addition. So, for consideration, I would strike the word "psychometric" but otherwise keep the existing language, and I would suggest adding an acknowledgment that in order for the SEC to meet its obligation under Business Roundtable v. SEC to conduct economic analysis, it needs to determine that mandatory disclosure changes are material.
CO-CHAIR GRAHAM: Again, my first question is did we say this on April 13th?
CO-CHAIR HANKS: Yeah, we're only saying it now. I mean, I would support the thought, for sure, but I think as a summary of what we already decided and recommended, we didn't do that. We maybe should. If we were to do it, we could do it now, but that would actually have to be a separate discussion.
MR. YADLEY: I think it's a good thought. I would be inclined to delete the first sentence and start the second sentence with, "As part of this initiative, we recommend the commission conduct a study." And then at the very end, on the last line, "improved over the years" and strike the rest of that and state that such a study could enhance the commission's ability to make disclosure more relevant to investors so that it -- the general

thought is I think correct, and we did talk about it, and as was noted earlier, we've always asked for more data. And our absent member from California, that was one of the things he included in his statement.

CO-CHAIR GRAHAM: Okay. Fair enough. Catherine?

MS. MOTT: (Inaudible) agree. I'd just say I feel comfortable with the way Gregory has structured it.

CO-CHAIR GRAHAM: Okay.

MS. DAVIS: Could you -- could you just read it again, Greg? Thanks. Are you talking about the first sentence that's, "What is" --

CO-CHAIR GRAHAM: Your microphone.

MS. DAVIS: "What is appropriate"?

MR. YADLEY: Yeah, what is (inaudible). I'm sorry. Yeah, "What is appropriate," in the paragraph with "as part of this initiative, we recommend" --

MS. DAVIS: Got it.

MR. YADLEY: On the last -- and then on the last line, Julie, after the word "and," cross out the rest of that and substitute "such a study would enhance the commission's ability to make disclosure more relevant to investors."

MS. DAVIS: Got it. Thank you.

CO-CHAIR GRAHAM: And did you get J.W.'s?

MR. VERRET: Maybe a friendly minute to the -- your language "and meet its obligation under BRT v. SEC to conduct economic analysis and determine materiality." That'd be --

MR. YADLEY: I'm going to wear a tie just like yours next time.

(Laughter.)

MS. DAVIS: So "and to meet its obligation under BRT v. SRC, or SEC, to conduct economic analysis." Was there anything after that?

MR. VERRET: "And determine materiality."

CO-CHAIR GRAHAM: Okay, anything else on 13? Actually, that was 14. Anything else?

(No response.)

CO-CHAIR GRAHAM: All right. Fifteen. I guess a couple of things. We have -- let's start with pruning the proxy process. I'm not sure, you know, to what extent we have spent time discussing this particular issue. It may be a valid point, but we -- I don't think we've spent developing any kind of consensus with respect to it.

MR. YADLEY: Good points but we haven't talked about it.

CO-CHAIR HANKS: Say, put it on the agenda for the next committee.

MR. REARDON: Yeah, all you're doing is -- well, first of all, I didn't understand that we were limited in -- I thought this point here, we were considering these things. But it wasn't my intent to pull the rug out from anybody -- under anybody by putting new stuff in here. I thought we were open to new stuff. But --

MS. TIERNEY: Can we have a section at the end for additional proposals to be --

MR. REARDON: Yeah, I think -- I think you can. I think there's -- Julie, don't the bylaws provide for a separate section if differing opinions, in the bylaws of this committee? So I think you can have -- or maybe Sebastian knows.

MR. GOMEZ: Well, this report is entirely voluntary, so it's not something that's required. So you as a committee get to set forth what, if anything, you want to include. In fact, even the whole point of the report itself is something that it's a decision of the committee, and none of it is required. So I think there is a lot of flexibility.

MR. REARDON: None of it's required. And to the extent they don't -- the committee as a body doesn't incorporate any of these, I'm free to send my own letter that says -- I or anybody else can join me in sending --

MR. GOMEZ: That's correct.

MR. REARDON: -- sending -- making these same points if you choose not to do it. So that remains a possibility that I'll just do it myself, or if anybody cares -- is -- anybody is wise enough to join me --

(Laughter.)

MR. REARDON: -- to -- in doing that. I will probably just do that myself with anyone else who cares to join me. But if you want to take it out, that's fine.

CO-CHAIR GRAHAM: I think it's -- I'm happy to hear the views of others, but I'm inclined to take out these last few paragraphs because we haven't spent time to try to develop a consensus. And as far as, you know, coordination down the road, I think these are good points, but I think we're more into policy recommendations and less into governance. (Inaudible) suggestions that we as individuals can certainly make, and I think they're probably valid suggestions, but I'm not sure if I want to put this in the committee report.

So (inaudible) open to other comments.

CO-CHAIR HANKS: I agree with that. I would look forward to Patrick's letter, which may be even more entertaining when it's under his own name only.

MR. REARDON: I can make it as entertaining as you want.

(Laughter.)
CO-CHAIR GRAHAM: Okay, that gets us to page 16. Annemarie?
MS. TIERNEY: In the secondary market liquidity section, did the committee also recommend the adoption of a new second trading exemption that ultimately was sort of along the lines of what happened with 407? I thought that you made a recommendation to adopt a new safe harbor for -- that would be worth noting here too.
MR. GOMEZ: Annemarie, will you send us some language for that?
MS. TIERNEY: Of course.
MR. YADLEY: Stephen?
CO-CHAIR GRAHAM: Yes.
MR. YADLEY: The additional paragraph at the top of page 16, if you're inclined to include that --
CO-CHAIR GRAHAM: I was not inclined to include that.
MR. YADLEY: Okay.
MS. TIERNEY: (Inaudible), that was my favorite.

CO-CHAIR GRAHAM: Eighteen?
(No response.)

CO-CHAIR GRAHAM: Okay.
(Laughter.)
CO-CHAIR GRAHAM: All right. Well, again, thank -- thank you all for reading this. Thank you all for your participation and your contribution to the 17 recommendations that have been made over the years and those recommendations that reflect kind of our participation in moving the ball forward, and also those recommendations where we think work still needs to be done.
So I guess what I would do now is entertain a motion that we adopt this report as amended.
MS. TIERNEY: So moved.
MR. REARDON: So moved. Second.
CO-CHAIR GRAHAM: Okay. Further discussion?
(No response.)
CO-CHAIR GRAHAM: Okay. All those in favor?
(Chorus of ayes.)
CO-CHAIR GRAHAM: All those opposed?
MR. VERRET: Just register an abstention, just because I'm late to the party and wasn't part of all the discussions. But I admire the committee's work a great deal, so --
CO-CHAIR GRAHAM: Thank you, J.W., and I would expect nothing less than an abstention from someone who

just got here. So, thank you. So the report is adopted.
Is that the last thing in this morning's agenda?
MS. DAVIS: Yes.
CO-CHAIR GRAHAM: All right. Then I think we can have a lunch break early.
MS. DAVIS: Yeah.
CO-CHAIR GRAHAM: Thank you.
MS. DAVIS: So we'll reconvene at 2:00. That's when the afternoon agenda says that we'll reconvene. So you have time for lunch and we'll see you back here then.
(Whereupon, at 11:35 a.m., a luncheon recess was taken.)
A F T E R N O O N S E S S I O N
CO-CHAIR GRAHAM: Okay, let's think about getting started. Sebastian, I think we have a returning quorum.
MR. GOMEZ: We do, if you count the people getting a --
CO-CHAIR GRAHAM: Over there.
(Laughter.)
MR. GOMEZ: -- few refreshments.
CO-CHAIR HANKS: We'll include them.
CO-CHAIR GRAHAM: Okay, everyone. Thanks for coming back. Hope you had a good lunch. Now it's time

for 701 and I'll pass -- I'll pass the baton to Sara.
CO-CHAIR HANKS: All right, thank you. It's a shame we don't have a very big audience, live audience, because this is really a very important issue for small companies. Securities Act Rule 701 provides an exemption from registration from securities -- for securities issued by non-reporting companies pursuant to a compensatory benefit plan for employees, directors, general partners, trustees, officers, or certain consultants. Issuers that sell more than five million of securities in a 12-month period in reliance on Rule 701 have to provide investors with recurring specified disclosure, including detailed financial statements.
Many growing companies compete for talent by granting compensatory stock options or other awards. With companies staying private longer and growing to higher valuations, there have been various legislative amendments proposed to expand and modernize Rule 701, which was last amended in 1999. The CHOICE Act, which passed the House of Representatives in June of this year, would have raised the five million threshold -- that's the threshold beyond which you have to provide the extra information -- for sales in a 12-month period to 20 million. This week, the Senate approved the Encouraging Employee Ownership Act, which has already been approved

earlier this year by the House, bumping up the point at which specified disclosure is required to 10 million, to be adjusted by inflation. Hopefully the President will sign that at some point soon.

Given the importance of incentive and award compensation for many private companies, we thought it would be useful to explore Rule 701 and whether there are any updates or other amendments that might be warranted. We're joined today by an expert in this area, Christine McCarthy, a partner who focuses on compensation and benefits in the Technology Companies Group at the law firm Orrick. Christine's practice focuses on equity and executive compensation plans and programs for private and public companies with a particular focus on late-stage public -- private companies.

Christine is joined by Steve Miller, the chief financial officer of Warby Parker, a privately held stylish eyeglass company that offers designer frames for $95. Certified as a B corporation since 2011, Warby Parker has been growing significantly over the last few years, and so we're looking forward to hearing about their experiences using Rule 701.

Christine and Steve, thank you very much, and I'll hand it over. Christine, you're going first?

MS. MCCARTHY: Great. Thank you very much, and

thank you very much for having us here today. We're really excited to talk to you about Rule 701. It's an issue that's very near and dear to my heart, and we'd like to share with you some ideas we have around ways in which Rule 701 can be potentially improved.

So I'd like to just start with a high-level overview of Rule 701 just to set the -- set the stage. Rule 701 is an exemption from the registration requirements of Section 5 of the Securities Act for offers and sales of securities to certain individuals in compensatory transactions pursuant to compensatory benefit plans and contracts.

Companies that can use Rule 701 include companies that are not subject to the reporting requirements of the Exchange Act and companies that are not investment companies.

Rule 701 is used to issue securities to employees, consultants, officers, advisers, directors, general partners and trustees of issuers, issuers' parents, majority-owned subsidiaries, and the majority-owned subsidiaries of the issuers' parents. Those service providers can also receive securities if they are former service providers, so long as the offer was made to them while they were employed by or providing services to the issuer. And family members of those service

providers may also receive securities pursuant to 701 from those service providers pursuant to gift or domestic relations orders.

What is not permitted under 701 -- this is important because this comes up in a number of ways in our talk later today. Rule 701 is not available for resales of securities. Rule 701 is not available for plans or schemes that have the purpose of circumventing the compensatory purposes of Rule 701. And Rule 701 is not available for plans or schemes that technically comply with Rule 701 but are really aimed at avoiding the registration requirements of the Securities Act.

Rule 701 has several -- two limits: a hard-cap limit and a soft-cap limit. We refer to the hard-cap limit as the hard-cap limit because that's the limit in the number of -- total number of securities that a company can issue in a 12-month period. Pursuant to the hard-cap limit, a company in any consecutive 12-month period can issue securities up to the greater of $1 million in value, 15 percent of the total assets of the company, or 15 percent of the outstanding securities of the company.

It's important to note, too, that under Rule 701 there is no integration with other securities exemptions. So only shares and securities that are

issued under Rule 701 are counted against the limit.

The second limit under Rule 701 we refer to as the soft-cap limit. Under the soft-cap limit, if an issuer sells securities in excess of $5 million in any 12-month period, the issuer is required to provide additional disclosure to any recipient of a security under Rule 701 during that 12-month period. That additional disclosure includes -- it includes material terms, a summary of the material terms of the plan, it includes risk factors, and it includes certain financial disclosure. The financial disclosure that's required is the financial disclosure that's required under Reg A, and it must be current within 180 days of the sale pursuant to which the disclosure is provided.

Those changes -- before we get into the specific changes, we'd like to talk a little bit about the role of equity compensation in private company growth and development, why it's so important to private companies, and how 701 factors in.

Compensating employees and consultants with equity has become an invaluable tool for many private companies in the United States and is really important and critical for companies to have this tool in order to hire the talent that they need to hire to support the growth and development of the company.

At the earliest stages, some companies don't have the cash resources to pay service providers in cash, and oftentimes they'll look for ways to pay service providers either primarily or exclusively in equity. At later stages, equity compensation is critical in order for those companies to hire the talent they need to support the development of the company.

Many private companies, particularly those at the earliest stages, don't have the resources to comply with rules that are complicated or overly burdensome or costly to administer. The lack of resources available to private companies can create inadvertent compliance errors where there's complexity or cost associated with complying with rules.

Given the importance of equity compensation to private companies and the development of private companies, it's absolutely critical that the rules that are in place for these private companies are rational, not unduly complicated, and not too difficult to comply with.

MR. MILLER: Yeah, sure. Thank you for having me here. I'm the CFO of Warby Parker, which is a startup company that has been around seven years. We're somewhat mature in our development, but we still like to think of ourselves very much as a startup. I've had a few various

startup experiences, which I can talk about. I worked at a venture capital fund called Flatiron Partners. I worked for a financial data analytics firm called Majestic Research. I worked for a company called GameLogic, and now I am at Warby Parker. So I've been in the startup world in a number of different contexts -- as an investor and as an operator -- and I can say that equity compensation has always been a meaningful tool that a startup company can use to attract and retain talent. One of the hardest things that you have to confront as a startup company is really competing for talent and convincing people to come and work for your company, and one of the tools that we have which has been quite useful is equity and awarding stock options to employees.

So this topic is certainly near and dear to my heart as a person who's responsible for our equity compensation programs. Christine has helped demystify the topic for us, and one of the bigger issues that we've had as a fast-growing company is actually understanding how to interpret 701 and make sure that we're in compliance with it. So I think that there are a few things to keep in mind.

One, from my perspective, one is the difficulty and somewhat ambiguous nature of actually understanding

how to interpret the rule as a company who's trying to do many things all at the same time. That's number one. And number two, it's then making sure once you do understand how the rule actually operates, that you can operate within it and still attract and retain the right type of talent.

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MS. MCCARTHY: The first change that we'd like to talk about is a proposal to remove the requirement that consultants be natural persons. So Rule 701 is available to consultants and advisors only if those consultants and advisors are natural persons, they provide bona fide services to the issuer, its parents, majority-owned subsidiaries, or the majority-owned subsidiaries of the issuer's parent, and the services are not in connection with the offer and sale of securities in a capital-raising transaction and do not directly or indirectly promote the sale of those securities and maintaining a market in those securities.

Private companies hire consultants to perform services for the company routinely. It's very, very common, particularly at the early stages, for private companies to hire consultants who are providing services

that employees would normally hire -- perform. For example, it's very common for early-stage companies to hire consultants -- their CFOs as consultants at the earliest stages simply because they don't have the resources to hire people full-time. So it's very important for companies to be able to hire these consultants and to be able to effectively compensate these consultants.

Many of these consultants choose to organize themselves in the form of an entity, even if they are just one individual providing services. The reason for that is it's efficient from a tax perspective and it protects them from liability. So it's very, very common for us to see companies engaging individuals who are providing employee-like services to private companies in an entity form, and having the rule structured so that it's not permitted to grant equity under Rule 701 to someone who's providing services as an entity is problematic. It causes companies to have to jump through hoops, effectively, in order to figure out ways to get these individuals that are providing services to the company equity.

In the preamble to the 1988 release, when Rule 701 was first adopted, there was some concern expressed about including consultants at all in Rule 701. And the

SEC indicated that it thought this concern was unfounded. The concern was that including consultants as available recipients under Rule 701 might cause Rule 701 to be abused for non-compensatory purposes. So in 1988, as I said, the SEC indicated they didn't agree with that conclusion, thought it was not warranted, and adopted the rule with a broad-based definition of consultant that did not have any reference to whether or not that consultant was a natural person or entity.

In 1999, when Rule 701 was amended, again, the preamble to the 1999 release talked about concern related to abuse of 701 where equity was granted to consultants in a manner which people felt was abusive as it was non-compensatory. As a result of that, the SEC decided at the time to structure the rule so that consultants and advisors had to be natural persons in order to receive equity under Rule 701.

In looking at that now, we propose reverting to the original rule, which doesn't require consultants to be natural persons. It seems that there's no clear rationale expressed in the 1999 release for adding the requirement for natural -- for natural persons to receive equity under Rule 701. The only reference in the release was to this concern related to the abuse of Rule 701 for non-compensatory purposes, and we think that excluding or

including consultants on the basis of their status as a natural person or entity is not directly related to that goal of avoiding abuse of Rule 701 for non-compensatory purposes.

We also feel that if there is concern related to the abuse of Rule 701 for non-compensatory purposes, that the more appropriate avenue is to enforce the rule that already exists, that prohibits the use of Rule 701 for non-compensatory purposes.

MR. MILLER: Just to provide some color on the consultant topic, we've worked with a range of consultants at my current company and also at my previous companies to help us get up to speed on a range of different items like supply chain analysis, general public relations, legal services, temporary CFO services, and the like. So the use of consultants, it's not really confined to one specific topic or area. It's really dependent on what the particular company needs.

MS. MCCARTHY: The second item that we'd like to talk about is eliminating what we're referring to as the hard-cap limit. When Rule 701 was first adopted, it was adopted pursuant to Section 3(b) of the Securities Act, which authorized the SEC to adopt an exemption up to a $5 million threshold such that the exemption could be created so long as it had a limit on the total number of

securities that could be issued in reliance on that exemption of $5 million.

In 1988, the SEC, pursuant to this authority, adopted Rule 701. In 1996, Congress enacted the National Securities Market Improvement Act of 1996, which gave Congress the -- which gave the SEC the authority to provide exemptive relief in excess of the $5 million limit and effectively remove the $5 million mandatory limit, and in the legislative history, encouraged the SEC to use that authority to remove the limit from Rule 701.

Rule 701 was amended in 1999, pursuant to its current form. In the preamble to the 1999 release, pursuant to which Rule 701 was amended, the staff stated that the increase in the limit was made to provide issuers with the flexibility they need without creating opportunities for abuse. Again, there seems to be a focus on preventing opportunities for abuse where Rule 701 could be used for non-compensatory purposes, and it seems that the limit was retained in order to prevent abuse of Rule 701 for non-compensatory purposes.

Compliance with the hard-cap limit requires ongoing analysis and it requires a substantial amount of work on the part of companies, and there's no real clear rationale for the limit. The limit, again, similar to

the natural person requirement for consultants, isn't directly aimed at preventing abuse, abusing Rule 701 for non-compensatory purposes. The fact that there's a limit has no impact on whether companies would use Rule 701 for non-compensatory purposes. It limits the total amount of securities that could be issued pursuant to Rule 701.

We feel the limit is not directly related to the purpose of the -- of -- that was trying to be achieved by the SEC in adopting the limit, and it doesn't otherwise curb abuses of Rule 701. Again, we think that if the desire is to curb abuse of non-compensatory issuances, that the appropriate approach to that is to enforce the rules that currently exist that do not allow the use of Rule 701 for non-compensatory purposes.

(Inaudible) a little bit about the challenges in complying with the rule?

MR. MILLER: Sure. So we grant stock options on a regular basis throughout the year. We currently have four board meetings, and typically at each board meeting we approve stock option grants and then we might approve outside of each board meeting option grants another four times a year. And every time that we put forward a round of grants, we have to understand whether or not we're going to bump up against the $5 million limit. Previously, we did that using a spreadsheet and

we were never quite sure if the numbers were accurate, and we weren't entirely sure how to understand the nuances of the law.

It's only recently that we actually had the resources to put in place a legal department, and we've implemented a tool called eShares, which has automated the process of actually doing that 701 check, which has made my life a lot easier; it's made our legal team's lives a lot easier and my controller's life a lot easier. It's still a challenge, though, because you want many things as a startup company, and one of the biggest things that you want is flexibility to make decisions, and hiring decisions are your most important. And what we've started to do is particularly in the context of equity and equity grants, make sure that before we make a hiring decision, particularly of a senior executive, that we're going to be in compliance with 701. And it's an added step in the decision chain that we didn't used to have to go through, so it just adds complexity to the process from a few different -- from a few different aspects.

MS. MCCARTHY: The next item we'd like to talk about is adopting a rule that excludes material amendments from the calculation of the Rule 701 limit. Rule 701 doesn't explicitly or expressly address

amendments to securities that were previously issued under Rule 701. However, C&DI 271.10 requires issuers to count stock options that are repriced as new grants and new sales under Rule 701 as of the date of the repricing. We recommend adopting a rule that clarifies that material amendments to any security that was previously issued under Rule 701 does not result in a new grant or a new sale for purposes of Rule 701.

The repricing rule itself can cause companies to exceed the hard-cap limit and the soft-cap limit at a time when no additional securities are being issued. There is no new grant. All that's happening at that time is the stock option exercise price is being reset in order to continue to assure the compensatory purpose of the security that was issued.

Requiring repriced options to be counted against the limit at the time of the repricing can often cause the limit to be exceeded because oftentimes what happens is companies are not performing for quite a long time at the time that they decide to do a repricing. Companies don't reprice all the time. They wait until the company has experienced a long downturn in the business before they take that step to reprice options.

So you can have situations where companies are repricing options that are granted over three, four or

five years, and treating those grants as if they're all granted -- re-granted on one date, the repricing date, can cause the limit to be exceeded just as a result of the repricing.

MR. MILLER: And it poses an interesting decision for management. Thankfully, I haven't needed to go through a repricing yet, but the notion of doing a repricing is something that you want to do for the benefit of employees. For whatever reason, business operations haven't gone as planned, your stock isn't as valuable as it was before, and employees end up with underwater options, and so you want to do the right thing by your employees. And one of the things that you would do in a situation like that is repricing stock options, and the way that the legislation works today, there's actually a negative incentive to do that because potentially by doing that, you would trip this threshold and then be forced to go through what would for all intents and purposes be like public company financial reporting.

So this is an area that I certainly haven't dealt with specifically from the context of having to go through a repricing, but I think the intent of the discussions that we're having is making sure that this type of legislation promotes doing the right thing for

employees, and I think this is a very specific example of where me, in my role as CFO, there would be an incentive not to necessarily do the right thing by employees according to the letter of the law.

So I think it's important to just highlight that there is that disconnect as it stands today.

MS. MCCARTHY: And we have seen companies who are facing this issue choose to reprice only options held by executives to minimize the impact on the limit, the hard-cap limit and the soft-cap limit. We have also seen them choose to reprice only executive options because they choose to use an accredited investor exemption rather than Rule 701. And this goes to Steve's point that they only are choosing to do that because they can't do a broader repricing without exceeding the hard-cap limit under Rule 701.

We would propose that in addition to making clear that a repricing is not a new grant or sale under Rule 701, that the rule, the proposed rule, would cover all material amendments to any securities previously issued under Rule 701 so long as they don't result in a new issuance of a security. So, for example, changes to vesting provisions, other material changes to the terms of the grant. Again, this is not addressed currently under the rules, and it's not addressed in the C&DIs, but

we think any rule that would cover this topic should cover any material amendments to any securities previously issued under Rule 701.

The next item that we'd like to talk about is clarifying the option -- the application of Rule 701 to restricted stock units. Rule 701 currently has no rules that specifically discuss and apply to restricted stock units. At the time that Rule 701 was adopted, private companies as a general matter were not granting restricted stock units, but it has become a form of equity compensation that many private companies have started to use, and the fact that restricted stock units are not specifically addressed in Rule 701 creates ambiguity in a number of ways that we think would be helpful to resolve.

So we recommend clarifying the rules as they relate to RSUs. We recommend clarifying that RSUs are considered sales on the date of grant, similar to stock options. RSUs are derivative securities, just like stock options, where no shares are issued unless and until the RSUs vest and settle. We also recommend clarifying that RSUs should be valued at the value of the shares underlying the RSUs as of the date of grant.

The next item that we'd like to talk about is the timing -- rationalizing the timing of the expanded

disclosure obligation and the measurement period applicable to the soft-cap limit. The way that the soft-cap limit currently works is if an issuer exceeds $5 million in securities issued pursuant to Rule 701 in any 12-month period, that issuer must provide expanded disclosure to the recipients of those securities in that 12-month period.

The problem is you may not discover that you exceed the limit, the $5 million limit, until the end of the 12-month period. However, you may have sales that occur at the beginning of the 12-month period that are technically required to receive the disclosure. This sets up a very difficult situation for companies because companies are effectively forced to guess or predict whether they'll exceed the $5 million limit in any 12-month period in order to ensure that they're providing the required disclosure so that they don't have a violation of the limit.

We recommend chancing the rule to provide that the expanded disclosure is not required until after the threshold is exceeded. The current rule is impractical in application and has no clear rationale.

Consideration should also be given to whether there might be a buffer period after the threshold is passed to give companies the time to pull together the

disclosure that's required to be provided. So, for example, if you've crossed over the threshold on January 1st, you might be given three months to prepare the disclosure and start providing the disclosure to sales that occur after that time.

The next item we'd like to talk about is clarifying the timing and delivery requirements of the expanded disclosure. Rule 701 currently requires that the expanded disclosure be provided a reasonable period of time prior to sale, or for stock options or other derivative securities' exercise or conversion. There's a lot of confusion amongst practitioners in companies as to what that means, what a reasonable period of time prior to sale is. There's no guidance currently that provides any help in determining what a reasonable period of time prior to sale is.

We recommend revising the rule to provide that any disclosure delivered at any time prior to the sale such that the recipient has an opportunity to review the disclosure will satisfy the obligation to deliver disclosure.

We also recommend revising the rule to provide that making the disclosure available in any manner consistent with the SEC's electronic disclosure rules, i.e. in an online data site, for example, satisfies the

obligation to deliver disclosure and that there's no requirement to confirm actual receipt or review of the disclosure. This is an item that actually has come up from time to time with my clients, where there is concern that even if the disclosure is made available and properly delivered, that they're not able to confirm that the email has actually been opened or the data site has actually been accessed and the disclosure has been reviewed, and there are some questions about what level of certainty is required in order to confirm that delivery is complete, and it would be helpful to clarify that.

Finally, we recommend revising the rule to provide that making the disclosure available in a physical location that can be accessed by the individual satisfies the obligation to provide disclosure.

The next item we'd like to talk about is conforming the timing of the disclosure obligation for options and restricted stock units. As I mentioned just a few minutes ago, Rule 701 provides that disclosure must be provided to option holders a reasonable period of time prior to exercise. C&DI 271.24 requires the disclosure to be provided to RSU holders a reasonable period of time prior to grant. In adopting the C&DI, the SEC distinguished between stock options and other derivative

securities that are exercised or converted and restricted stock units, which they acknowledged are derivative securities but they indicated are not exercised or converted.

We recommend adopting a rule that conforms the rule for options and RSUs. RSUs are derivative securities; they are settled rather than exercised or converted, but we think that's a technical difference that shouldn't make -- a technical distinction that shouldn't make a difference. And we recommend, again, conforming those rules.

The next item we'd like to talk about is decoupling expanded disclosure from Reg A and simplifying the required disclosure. What we're talking about here is the financial disclosure that's required pursuant to the expanded disclosure requirement. The expanded disclosure, the financial disclosure that's required is the financial disclosure that's required under Reg A.

Reg A was recently revised, creating a significant amount of complexity and confusion with regard to its application to Rule 701. Some of this complexity was addressed in a recent C&DI which allows issuers to choose to follow the requirements of Tier 1 or Tier 2 of Reg A. However, a substantial amount of complexity continues to exist in terms of how Reg A is

applied in the context of Rule 701.

We recommend simplifying the disclosure required under the expanded disclosure requirement by decoupling it from Reg A, and instead requiring a current balance sheet and income statement. In the legislative history to the 1999 release, the SEC stated they thought the Reg A disclosure was a type of disclosure that many private companies would be familiar with, suggesting that the financial disclosure required under Reg A would not be unduly burdensome or difficult to comply with. In practice and what we see with companies is this is not generally true. The level of disclosure required under Reg A for companies that are first subject to the disclosure rules is substantially more burdensome than what most private companies are used to having to provide, and companies often incur significant expense and spend a significant amount of time putting together that disclosure.

Although audited financials are technically not required under the rules, many companies also feel that they need to provide disclosure that's effectively equivalent to audited financials in order to ensure that the financial disclosure complies with the rules, which requires compliance with GAAP. They also have questions about whether footnote disclosure is required where it

might be required under GAAP, and there's just a lot of ambiguity in terms of what companies can do and what it means to provide GAAP-compliant financial disclosure that's not audited.

MR. MILLER: Sure. So one of the benefits of being a privately held company is that you can maintain a higher level of confidentiality over your financials, for a number of different reasons. I think one of the positive aspects of Rule 701 is that it encouraged transparency, and I think in general it's good to operate in a transparent way, whether you're a privately held company or whether you're a public company.

But while you are a private company, it takes quite a bit of time to put in place the people, processes, systems, infrastructure to operate as a public company would, and in particular it takes a fair amount of time and effort to put together GAAP-compliant financial statements and to go through the audits that you would want to go through from your accounting firm so that you can put financials in front of employees in a way that you feel are accurate and are not going to change. Particularly if you are a private company that is potentially going to become a public company, you don't want to be in an odd position of having put out financials which say one thing and then when you're

filing your S-1 they say something completely different.

So I think it's a very important topic just to think about in the context of how you want to spend your time as a startup company executive. Is it putting together financial statements, which we do -- we do now better than we did before; putting together risks and various disclosure statements; or is it actually operating the day-to-day of your business?

So I think there is certainly a fine, fine line between transparency and between creating an undue burden on companies. I'm a big proponent of transparency and we do what we can, and we tend to go above and beyond what most private companies do to report on their financial performance to their employees. But at the same time, it's important to bear in mind putting in place anything that would be too onerous for a private company to comply with to create and put forward financial statements for this particular exercise.

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MS. MCCARTHY: The next item we wanted to talk about was changing the frequency in which the financial disclosure must be updated. As I noted at the beginning of the talk, the financial disclosure must be dated as of a date that's within 180 days of the sale. We think that when this rule was first adopted, the expectation was that that would mean that the financials would need to be updated every six months. However, as a practical matter, it takes time to prepare the financials and put them in a form where they're ready to be delivered, which means that companies that are required to provide the financial disclosure actually have to update and provide the disclosure quarterly. So it's really a quarterly obligation and not a semiannual obligation.

We recommend revising the rules to require the financial disclosures be updated and provided once a year unless a material event results in a material change in the enterprise value of the company or the value of the securities to be issued. The current rule with quarterly reporting is unduly burdensome and costly for private companies. It requires a tremendous amount of resources for them to put together the financials each and every time that they're put together, and quarterly seems to be too much.

The proposed rule, as we've written it, generally conforms to an IRS rule that private companies look to when they are setting the value for pricing their stock options. It's referred to as 49a, and it's very similar in terms of how it's structured where you can rely on a valuation for up to a year unless a material event occurs that would require you to provide it more frequently. And we think that that standard strikes a good balance between ensuring that the disclosure is adequate and the cost and burden of putting together the disclosure.

The next item we'd like to talk about is conforming the consequences of a violation of the expanded disclosure requirement and the hard-cap limit violation. A violation of the hard-cap limit results in the loss of Rule 701 for any securities that are sold in excess of the limit. A violation of the expanded disclosure obligation, however, results in the loss of the Rule 701 exemption for all securities that were sold during the relevant 12-month period. We recommend conforming the consequences of violating the expanded disclosure obligation with the consequence of violating the hard-cap limit such that only those sales pursuant to which the expanded disclosure is not provided are the sales that lose the Rule 701 exemption.

Oftentimes a failure to provide expanded disclosure is an inadvertent result of an administrative error. Sometimes it's a technical error where access is not provided via an online data site. There's no clear rationale for the punitive result that currently exists where the Rule 701 exemption is lost for all sales that occur in that 12-month period.

Under the proposed rules as we've conceived it, if there is broad-based failure to provide disclosure, then there would be a broad-based loss of the exemption.

Finally, and this may be now a moot point, we'd like to propose that we increase the soft-cap limit from five million to 10 million dollars. We understand that legislation has been passed and is waiting for the President's approval, so happy to go through it, but I think we may be there. I'm happy to --

MR. MILLER: Fast results.

MS. MCCARTHY: -- take any questions, and again, thank you very much for allowing us to talk today.

CO-CHAIR HANKS: Thank you.

MR. MILLER: Thank you.

CO-CHAIR HANKS: So, questions.

MS. MOTT: This is not a question, this is a comment. I'm on the board of many startup companies,

several, and everything you recommend seems very reasonable. My question might be for Steve maybe to talk -- if I have a question here. Could you describe, you know, as the company has scaled, how this has -- you know, and you continue to do -- obviously, you're using eShares now. But, you know, I can imagine the complexity of this, and particularly when your valuations are changing if you're taking on additional rounds. So can you maybe highlight that a little bit for folks and just give us a picture of what it's like in the world of Warby Parker?

MR. MILLER: Sure, sure. And it's certainly evolved over time, and we're in a much better place right now to track and comply with Rule 701 in more of an institutional way. But when I joined the company over six years ago, there were maybe 30 to 35 employees at the company. There was no finance department. I walked in and had to figure out how to understand our financials and hire a team and get involved in various other initiatives across the company. So in the early days, the thought of complying with Rule 701 wasn't even in the cards for me, and it probably wasn't until a year or so later that I became more aware of this particular topic, just because I was much more focused on other areas, we didn't have a general counsel, we didn't have an in-house

lawyer.

So fast-forward, you know, from six years ago to today, we now have an accounting department of approximately eight people and growing. We've got more specialized functions and we're taken the time to understand the topic and actually select a technology tool from a company which is itself a startup, a company called eShares, that has really helped us automate the tracking of this particular topic in a much easier way.

So it's definitely been an evolution, and I remember the first time that counsel pointed this out to me. I was like a deer in the headlights. And then it took some time to understand the nuances; it took some time to build a team; it took some time to select a tool. And we're in a much better spot right now.

I hope that addresses what you were getting at, or --

MS. MOTT: Yeah, and I think about other issues of scaling. I mean, you're trying to think about, you know, there's -- you're juggling a lot of things. But I think, has it ever impeded your ability to hire talent, be able to offer something to attract the kind of talent you need? You looked at this and said, oh gosh, we're near our limit; we can't do it? I mean, have those kinds of things existed for you as the company continues to

scale?

MR. MILLER: Yeah, it's made us think about option grants with more forethought ahead of time, and we've actually been in a situation where had we not taken advantage of the accredited investor exemption, we would have exceeded the $5 million limit.

MS. MOTT: That's what I was looking for, yeah.

MR. MILLER: Yeah. Yeah, for sure. So it's definitely made us approach this area with a lot more caution, and when you're a startup company, you prize flexibility, you want to be nimble, you want to make quick decisions, and this is certainly an area which has added additional headwinds into the process.

MS. MOTT: And the cost of valuations, right? When you -- I mean, do you do 409A or what are --

MR. MILLER: We do, we do.

MS. MOTT: Yeah.

MR. MILLER: So every company has to deal with the 409A valuation process. And again, I understand the intention of the process, but there's oftentimes a large difference between the 409A and the real-world value, but we all rely on the 409A value and we have to update that value certainly at least once a year; when you're a more mature company particularly with an eye to going public, you want to do that at least once a quarter if not more

often, and you want to change from one methodology to another methodology.

So it becomes quite complicated. It's a process that we go through now on a quarterly basis, and it's quite costly because we involve a number of parties. There's our third party stock option valuation firm, which does our 409A values. We run all of our valuations past our accounting firm. We work with Ernst & Young. And there's typically a back-and-forth set of conference calls between the two, so we're ringing up fees in the process.

And then it requires my controller to put together historical financial statements amongst a number of other items on a due diligence request list. We then include in analysts from my financial planning and analytics team to put together updated -- an updated set of projections. And then we finally arrive at the value, which we would then use as an input to understanding whether or not we would bump up against the $5 million limit.

So it -- as I'm talking through this, you're reminding me how many parties are actually involved, how complicated the process is, how much time it takes, and how much money we actually spend on this.

MS. MOTT: So I see how easily this -- you

could inadvertently bump up against things, particularly when you're a startup with limited resources and not having the ability to pay for some of these things, right? Especially when you're trying to scale and compete. So I appreciate both what you're -- what you've done today and what you said today, and I think it's clarified, you know, many things here.

MS. MCCARTHY: We do in practice come across companies who have exceeded the limit, either the hard-cap or the soft-cap limit, without realizing that they've done so. We take them over as clients and maybe they didn't have the resources in place to really properly track the limits. And that often then requires them to go through a very expensive process of trying to figure out, can we remove grants that were made -- that we thought were made pursuant to 701 that we need to rely on accredited investor exemptions for? Can we remove all of the grants that have, you know, been canceled? And it's a very, very expensive process.

CO-CHAIR GRAHAM: We don't -- sorry, we don't take questions from the audience. Want to join us?

AUDIENCE MEMBER: (Inaudible.)

(Laughter.)

MR. YADLEY: While you're clarifying that, you mentioned revising the rule to be able to provide

documents in a physical location. I assume that's for confidentiality. What would you like to do that should be addressed in the rule?

MS. MCCARTHY: Yeah. So we'd actually like the rule to state just that, that so long as the individual has the ability and the means to access the physical location, that providing the disclosure physically will satisfy the rule of delivering the disclosure. There's some concern that doing it in that way won't satisfy the delivery requirement because the SEC may view that as not sufficient or adequate for the individual to actually sit down and review the disclosure, that they may need to physically receive it to be considered to have delivered the disclosure to them.

MR. YADLEY: Right. So if, for example, an employee wanted to (inaudible) advisor or accountant --

MS. DAVIS: Could you talk a little closer to the mic? Thanks.

MR. YADLEY: Sorry, to have -- if the employee wanted a financial advisor, attorney or accountant to look at it, they may not be able to do that.

MS. MCCARTHY: Yeah, as a general matter, that's not permitted even when the disclosure is delivered electronically. The disclosure is generally delivered in a way that requires the individual receiving

the disclosure to maintain the confidentiality of the disclosure and not just share it with any parties. Sometimes there are exceptions to that, but most companies have a very strict rule on that, that it's really the disclosure goes only to the individual and not beyond the individual.

The concern, as you noted, is confidentiality. There's a tremendous amount of sensitivity to confidentiality amongst private companies who are not otherwise subject to public review and do not have their financial information publicly disclosed. There's real concern that having their financial information publicly disclosed will lead to competitive disadvantage for them, and so there's a lot of angst over this particular issue.

Delivering the disclosure via electronic sites and other methodologies sometimes is viewed as insufficient by some companies because they feel that people can, you know, take screenshots; there's other ways in which you can capture the information. It's very, very difficult to predict -- protect. Some companies will watermark the screen so that if you take a screenshot, it could be discovered later, you know, who was distributing the disclosure. But nothing is really fully sufficient to protect the information.

In the legislative history, the SEC mentioned

having people enter into confidentiality agreements, and I think as a general matter people feel -- people do certainly do that, but feel that it doesn't provide any real protection because then you have a breach of contract while your financial information is out and about. So the harm is just very -- potentially very severe.

MS. TIERNEY: So you know we work with a lot of private companies and we're big supporters of updating these rules and making the types of changes that you're suggesting. You know, another way to look at it is not just the burden to the company of the financials --

MS. DAVIS: The mic.

MS. TIERNEY: Sorry. We're all talking too low, Julie. Sorry. I've got high energy, Patrick. I just got a scratchy voice today.

One of the things that I think is -- the look-back never made sense to me. Right, the idea that you have to go back 12 months and you should be providing disclosure for 12 months. I never understood, like, the policy behind that, but it really hurts high-growth companies, right? So if you're having a great year and you have your 409A valuation done, that's when you found out that you've exceeded the five million number. And like, it just doesn't make any sense to me that the

current rules actually put companies as a disadvantage for being successful, so I really support what you're recommending.

MS. MCCARTHY: The idea of having to predict whether or not you'll exceed the limit is an idea that most of my clients look at me and think I'm crazy, that I must be misinterpreting the rule, because it really -- it really doesn't make a lot of sense and there is no real clear policy objective for that. And we have -- I have had a number of clients that have started providing disclosure during periods when they haven't exceeded the threshold because they are worried about having a violation; they're worried that their price will go up significantly and that they will exceed the limit, and the only thing that they can do in that circumstance is to start providing the disclosure.

MS. TIERNEY: I've got one more question. I think the way that lawyers interpret the rules, and I might be incorrect, is that once you start providing the disclosure, you continue to do so regardless of whether or not in the next 12-month period you go below five million. Is that right?

MS. MCCARTHY: I think, technically, everyone understands that you look at each 12-month period as a discrete 12-month period, and theoretically, if the value

went down during any period, you wouldn't be required to provide the disclosure to the grants and sales that were made during that period.

I think most advisers counsel their clients to provide the disclosure and to continue to provide the disclosure going forward to everyone, regardless of whether you go below the $5 million threshold. And the reason is it's too hard to pick and choose who you're sending the disclosure to and it's too easy to make a mistake, and it's -- the penalty is too extreme because you lose the -- you lose the Rule 701 exemption for everyone in the 12-month period.

So, in fact, in addition to the situation that you just described, most companies will start providing disclosure to everyone who's holding an outstanding option at the company regardless of when it was received, once the company starts providing the disclosure, and that's a big part of the reason.

CO-CHAIR HANKS: And disparate information is always going to be a problem anyway.

MS. MCCARTHY: Yeah.

CO-CHAIR HANKS: Just sort of to look at the soft cap, is there a point to the soft cap at all, in your opinion?

MS. MCCARTHY: To provide -- look, the soft cap

triggers the financial disclosure, which I think is the primary purpose of --

CO-CHAIR HANKS: Yeah, but is -- is there a point to actually providing that? I mean, if it's okay under the amount and investor protection is served under, then you get into the arbitrary -- I mean, like, there's a huge element of arbitrariness. Does it actually add to investor protection in the type of companies that you're working with?

MS. MCCARTHY: I would say it probably doesn't because it's often the case that people receive grants very early on at the company, option grants, and they don't exercise those grants until the company goes public or after the company goes public. And in that case, you know, the exercise price may be low, so the actual investment cost, the exercise price cost may be low, but the total cost of the transaction can be very, very high when you factor in the tax costs.

So what I would -- my understanding of the purpose of the rule is to protect investors, and where -- the idea is where the cost and the investment is significant enough that at that point it becomes important to protect the investor and provide them with some disclosure.

But as I just explained, there's no reason why

the earliest investor shouldn't be protected just like the latest investor, and therefore, what's the difference?

MR. YADLEY: But isn't -- I mean, and that's sort of the point here. If these are compensatory transactions and you're getting this as part of your compensation, and you're happy to get them, and they're options (inaudible) documents, things that are going to have future value, you hope. Why do you need disclosure at all here? When it's time to make an investment decision such as exercising it, I agree you should (inaudible). I am certainly in favor of dealing with the soft cap.

MS. MCCARTHY: I think there would be a good justification for doing away with the soft cap and the disclosure requirement altogether for RSUs, which actually requires no action on the part of the recipient. They receive the grant; at the time of receipt it's a non-event, it's a contractual right to shares in the future after the shares vested are settled. At that time, they receive the value -- they receive the shares, which is a taxable event, but there is no action that they take in order to receive that value.

MR. YADLEY: Right, I haven't worked with any startup companies that say, "Here's your options, but if

you don't want them we'll give you cash instead."

(Laughter.)

MS. MOTT: Doesn't work that way. So, Gregory, you brought up something I think that's really important in the scheme of this, is that if they're worth anything later, right, because how many of these companies don't, you know, get to the point of Warby Parker or, you know, or to an exit. So since it's something -- a contractual right for something in the future, it's only relevant in the future if it turns into something, and the same thing with valuations. It's so gray. It's such a gray area in this asset class. So, glad you brought that up.

MS. MCCARTHY: And for RSUs, since there's no action taken in order to settle the RSUs, it's inconceivable in my mind that someone would turn their back on the RSUs as a result of receiving disclosure and say, "No thank you, I'm not interested in receiving these shares because they are worth less than I thought they should be."

MS. TIERNEY: I would also say that being a former employee of a private company, you make your investment decision when you take the job, right? You've -- you're agreeing to take equity as a big part of your compensation going in the door, so I think you're making that investment decision as part of your career. And I'm

not given financial statements when I take the job, right, so I don't get what it gets me later on.

MS. MCCARTHY: And the assessment that candidates do in that process, too, is a much more generalized assessment than, you know, a review of financial statements. It's an assessment of the overall, you know, strength and opportunity at that business and where we think that business will head and what we think it will do, and do we think this is a good investment of my time and energy, you know, working for this business. Do I think it's going to grow and develop and be the next great thing?

MR. GOMEZ: Can I play devil's advocate there for a minute and just -- if -- and going to Annemarie's point, if I'm trying to make a decision as to whether this company is a company where I want to work, and by that also take part of my compensation in the form of equity rather than cash, doesn't that actually go to the point of wouldn't I want to know more about the company at the time that I am actually starting with the company to decide whether the $100,000 plus $50,000 worth RSU is comparable to that other offer that I got from another company that was $150,000 in cash and only $25,000 in RSUs?

MR. VERRET: Can I just respond to that?

Mandatory disclosure is not the only way for you to get what you require. You should negotiate for, as an employee, negotiate to receive those financial statements and say, "I've got another offer. I think I'm going there but maybe you can" -- I mean, you know, mandatory disclosure is not the only way to get access to information. I mean, that's an ongoing issue.

MS. TIERNEY: Right, but you're not getting access to financial statements when you're negotiating to start at a private company. I mean, that's not generally part of the onboarding process. It certainly wasn't at the company where I worked. Do you see that where you are?

MS. MOTT: So one of the things I -- so I'm thinking, okay, let's start with this -- the very beginnings of the company. You know, one of the things is we don't have a history of accounting records or anything. I mean, what you have are projections and they're based on a set of assumptions that are unproven. So when you're putting value out there, and particularly even still through, you know, maybe the second or third stage, it's hard to say what they're going to be worth, you know, I mean, to price things.

It's difficult enough when -- I will vouch for this as an investor -- to put a value on a company based

on a set of projections that are, you know, unproven, and they will continue to be unproven while the company scales. You know, what we all hope to be is that by the time it gets to be in its fifth year, it's at 50 million or 100 million or 500 million, whatever it is. You know, by then -- you know, and again, if it's a biotech company there's really -- it still continues to be really gray.

So, you know, I guess what I'm saying is that I hear what you're saying, Sebastian, but boy, as an employee, when I think about people who jump into Facebook or jumped into, you know, these startup companies, they were just like -- it's like this.

MS. MCCARTHY: Yeah.

MS. MOTT: You know? I mean, they're hoping it's going to be something big, but how big is it going to be and what does it mean to my bottom line, to my retirement plan, to anything like that. I'm clueless. I'm jumping on hoping that this -- I'm going to really work hard and try to make this worth something. And I'm sorry it's just like -- it's not -- it's not black and white in this world. It's really gray. I think --

CO-CHAIR HANKS: It's not usually even written down. I mean, speaking as a startup, I mean, our financial statements for the first three years were zero, zero, zero, zero, zero, zero.

(Laughter.)

CO-CHAIR HANKS: And then they were -- you know, we had some projections which were absolutely unrelated to reality in any respect and depended on certain people drafting rules at a specific time. But, yeah, it's -- I mean, people who joined us joined because they were like, "Yeah, this is a good idea -- like the team."

MS. YAMANAKA: If you have the financials, you'll take them, right? With a grain of salt of whatever they are. But I think when you're -- when you're willing to take that equity compensation, you're really looking more like the biotech. Like you said, it's like, "Can you pay my paycheck that you committed to, you know, next month? And what's your burn rate?" You know, and that's more relevant than, frankly, financial information at that particular time. And do you have faith in the product that they're going to be able to do something great? Not as great as the projections, because projections are always like whatever, but do I have faith in the people and can they support me from a cash perspective in an area that I'm comfortable with? Some people are comfortable, hey, one month and we're fine; other people, six-month reserves, nine-month reserves, whatever.

So it -- you look -- people who are willing to take this -- and I'll say I've been guilty of it too. You know, I'm an accountant and some things have just gone out the door because, yeah, these financials look really terrible but I really have faith in the organization and I'm willing to take a risk, and I can afford to take a risk.

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MR. MILLER: Expressing the value of stock options to employees is very much an imprecise science because literally, if you want to be honest with the person, and I think you always want to be honest, it's that these options could be worth nothing or they could be worth a fortune or somewhere in between. And it sounds like almost a very evasive answer, but it's really the truth. That obviously changes over time, so a company that's doing zero in revenue is very different from a company that's doing 100 million in revenue which is different form a company that's doing a half a billion in revenue and is profitable.

But particularly at the earlier stages of a startup's -- of a startup company's existence, you can talk about vision and you can talk about the future and

you can provide some parameters that would allow a person to do the basic math to value stock options. But the honest truth, particularly at the earlier stages, which I think is really what we're focusing on here, it's very, very much an imprecise science, and the people who tend to get attracted to startup companies have a few traits in mind. One just might be to need a job. Two, believe in the vision and are mission-driven individuals. Three, are risk-takers. Four, want to create something that's never been created before. And it's really those more emotive aspects of taking a job that would draw someone to a startup, and it's the option compensation which sexing -- that's secondary, is a strong word, because we do live in a capitalist society and we can point to tons of examples where people have made fortunes off of their stock options, but trying to put that into a scientific equation, particularly at the earlier stages, becomes very, very unrealistic.

MR. REARDON: I am a little -- well, I think my knowledge is out of date. If -- under 701, if I make the mandatory disclosure when I give stock options in another employee compensation, does that absolve me from making disclosure when those options are exercised?

MS. MCCARTHY: So the timing of the disclosure requirement for stock options is a reasonable period of

time prior to exercise.

MR. REARDON: Okay. So what's the purpose? Well, let's put the law under 701 aside for a second and just look at the general securities laws. If I give Catherine an option and she's an employee, I thought the rule was -- and the option is not in the money; it's either fair market value or at some higher value -- that that's not a securities transaction at that time. Is that correct?

MS. MCCARTHY: I think that there's a C&DI that actually says it's considered a securities transaction but it's not -- there's no requirement for an exemption or a registration at the grant of an option.

MR. REARDON: There's no purchase and sale -- purchase or sale.

MR. GOMEZ: The requirement for disclosure under 701 for an option --

MR. REARDON: We're forgetting about 701. Forget it. Just it doesn't exist. Okay, outside of 701.

MR. GOMEZ: So, Patrick, I can't live on a -- in a world where there is no 701 when we're talking about 701.

(Laughter.)

MR. GOMEZ: But I think the point that I wanted to make is that with respect to options, there is no

requirement to provide disclosure at the time of the grant of the option. The requirement to provide the disclosure, it's a reasonable time prior to the exercise.

MR. REARDON: Okay.

MR. GOMEZ: Which is different than what would happen with respect to a grant of common stock, preferred stock, or RSUs.

MR. REARDON: Okay, what about a restricted -- what is a restricted stock unit? Is that the same thing as a phantom stock right?

MS. MCCARTHY: It's similar. A restricted stock unit is a contractual right to receive shares in the future. So at grant, it's a piece of paper that says you're entitled to a certain number of shares at a certain time in the future, when -- typically when you meet vesting conditions and when the vesting conditions are satisfied, then the shares settle and you receive the shares.

MR. REARDON: But you don't pay any money.

MS. MCCARTHY: There is no purchase price paid at any time.

MR. REARDON: Again, is that a securities transaction?

MS. MCCARTHY: There is an ongoing debate about whether an RSU involves a sale, for securities purposes.

I think as a general matter, the SEC's view is that it is a sale transaction at the time of grant of an RSU.

MR. GOMEZ: There is a line of no-action letters that considers that there's instances where the grant of an RSU would not be a sale, and we call them -- I call them the no-sale-theory line of no-action letters. So when the staff issued that CDI, the staff noted in the CDI as well that companies may want to consider whether the no-sale theory applies to a specific grant of RSUs. Say, for example, every new employee that comes to the company automatically will get a grant of 500 RSUs and there's no negotiation, there's nothing else. So the staff in the CDI did point out to that as a way for companies to think as to whether they did, in fact, have something that triggered the company having to look at 701 or not.

MR. REARDON: Interesting. Do you make an 83(b) election on an RSI -- RSU?

MS. MCCARTHY: There's no opportunity to do an 83(b) election with an RSU because you receive the shares at the time of vest. So Section 83 and 83(b) elections are available for property that you receive that's subject to a risk of forfeiture. The time that you receive the shares pursuant to the RSU, it's not subject to a risk of forfeiture.

MR. REARDON: If -- what if you're fired?

MS. MCCARTHY: The piece of paper that you receive at the time of grant of the RSU is not property for purposes of Section 83 and the tax rules.

MR. REARDON: That's confusing.

(Laughter.)

MR. REARDON: Thank you.

CO-CHAIR HANKS: All right. Before we go into any more tax, I think it's time to move along, I think. And I don't know if we want to talk about possible recommendations.

CO-CHAIR GRAHAM: Well, first of all, thank you, Steve, and thank you, Christine. I thought that was -- that was very helpful (inaudible). It wasn't as much as the discussion, as we sat here and we learned from you. So I appreciate that.

MR. MILLER: Thank you for having us.

MS. MCCARTHY: Thanks again.

CO-CHAIR GRAHAM: Yeah. So you are free to go if you would like, or you can sit here and kind of keep observing us if that's what you would like to do.

MS. MCCARTHY: Great. Thank you very much.

CO-CHAIR GRAHAM: All right. Thank you.

Now, we weren't planning on making any more recommendations because we are -- we are nearly dead.

(Laughter.)

CO-CHAIR HANKS: We've got 15 minutes.

CO-CHAIR GRAHAM: But I think -- but I'm thinking a useful recommendation can easily be formed. And can I toss it to you, Annemarie, for in terms of just kind of stating a consensus?

MS. TIERNEY: Sure.

CO-CHAIR GRAHAM: I think that we should look -- okay, so this is my view, and we can -- and people can react to it. It seems to me that we've got some good ideas. It seems to me like generally speaking, we think that it would make sense to modernize 701 for the reasons that have been stated, and I don't think we need to spend a lot of time with a lot of detail in coming up with something that we'd view as a useful recommendation to the SEC. Does that make sense to people?

CO-CHAIR HANKS: Yes.

CO-CHAIR GRAHAM: So do you want to kind of give us some lead on that, Annemarie?

MS. TIERNEY: Can I just pass a resolution with what she said, or do we have to do it?

(Laughter.)

CO-CHAIR GRAHAM: I'll yell and (inaudible).

CO-CHAIR HANKS: (Inaudible.)

MS. TIERNEY: So, I mean, I think if I was

going to make a recommendation, it would be to --

CO-CHAIR GRAHAM: Because I know you've given this a lot of thought already.

MS. TIERNEY: Yeah.

CO-CHAIR GRAHAM: Probably more thought than any of the rest of us.

MS. TIERNEY: With a lot of smarter people than I am. So I'll just sort of parrot what I've learned, which is a longer distillation of what we learned today. I really do think the SEC is open to looking at this space, which has been really good to know. We know that the number, the soft-cap number is about to change to 10 million if the President signs it. But I really do think that the recommendation should be for the staff to take a look at 701 in the context of the testimony given today, particularly around RSUs. In my mind, the 12-month lookback that we don't seem to be able to find a policy argument for, although I'm sure there is one. I just don't know what it is. And the other items that Steve and Christine recommended in the slide deck. I think it's well worth the staff's time. I think, Sebastian, you mentioned that the legislation that may pass with the President's signature also directs the SEC to look at the 701 space, so this is a good opportunity for you to do so.

MR. GOMEZ: The -- no, it doesn't.
MS. TIERNEY: No?
MR. GOMEZ: But it does require the SEC to do rulemaking to implement --
MS. TIERNEY: Sorry, rulemaking.
MS. TIERNEY: -- the change between five million to 10 million.
MS. TIERNEY: So maybe it's a good time for the SEC to look at it as a broader category. We know that companies are staying private longer. We know that the five million number is tripping companies up, not through any sort of, you know, nefarious, you know, intent but just as actually an implication of hiring people, which we all support, and growth, which we all support.
So my recommendation would be to look at 701 in the context of Christine's recommendations, especially around the 12-month lookback, the RSU wrinkle, and --
CO-CHAIR HANKS: Natural person.
MS. TIERNEY: -- natural person, and proposed rules, proposed rulemaking.
CO-CHAIR GRAHAM: Okay, so it sounds like -- I mean, they just -- really, it was a great presentation. So it sounds like we can't -- I mean, I don't recall anything that was being recommended that I would take issue with.

CO-CHAIR HANKS: Yeah.
CO-CHAIR GRAHAM: So I think that's where we are. Can -- give us a second. More discussion? All those in favor.
(Chorus of ayes.)
CO-CHAIR GRAHAM: Opposed.
(No response.)
CO-CHAIR GRAHAM: All right. You can still stick around if you want. We're almost done. As --
MR. YADLEY: So J.W. got to contribute to the committee, and I think that's just great.
CO-CHAIR HANKS: There you go.
(Applause.)
CO-CHAIR GRAHAM: Yeah. You did not earn that, by the way.
(Laughter.)
CO-CHAIR GRAHAM: As you know, this is -- this is our last meeting, and I just wanted to say it's been a pleasure serving with all of you. It's been an honor to have occupied this position for the last six years. And I want to thank again the staff, especially you two. I think the staff has been great over this time in terms of (inaudible) support. And that's all I got. Goodbye, good luck, and safe travels.
CO-CHAIR HANKS: Thanks, everyone.

MS. MCCARTHY: Thank you.
CO-CHAIR GRAHAM: Adjourned.
(Whereupon, at 3:17 p.m., the meeting was adjourned.)
* * * * *

PROOFREADER'S CERTIFICATE

In the Matter of: SMALL & EMERGING COMPANIES ADVISORY COMMITTEE MEETING
File number: OS-0913
Date: Wednesday, September 13, 2017
Location: Washington, D.C.

This is to certify that I, Christine Boyce, (the undersigned) do hereby swear and affirm that the attached proceedings before the U.S. Securities and Exchange Commission were held according to the record, and that this is the original, complete, true and accurate transcript, which has been compared with the reporting or recording accomplished at the hearing.

_____ _____
(Proofreader's Name) (Date)

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