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PANEL 1: PLAYERS IN NEW CAPITAL MARKETS

MODERATOR: Simon Lorne
PANELISTS: Sophia Lee, Roy Smith,
Annemarie Tierney, Roberta Karmel

PROFESSOR GERALD ROSENFELD: So let's get on with the substantive parts. We've thanked everybody enough here and, again, my welcome to all of you, but let me turn the stage over to Si for this panel. Thanks.

MR. SIMON LORNE: Thank you, Jerry. Let me introduce the panel for the next session. We're going to be talking about new players in the capital markets. We're going to be talking about the extraordinary changes in the last several years in the capital markets and what questions come out of those changes themselves and the effect of those changes on the corporate world.

Going down from my left, I'll start with Sophia Lee. Sophia is Deputy General Counsel of Liquidnet Holdings, which brings together equity investors and block liquidity. Sophia is a graduate of this law school from 1996?

MS. SOPHIA LEE: That's correct.

MR. LORNE: And the school is, of course, proud to have her back. And we look forward to her comments. Next to Sophia is Roy Smith, who needs no introduction, but will get one anyway as is common. Roy Smith had a substantial and distinguished career at Goldman Sachs before trading that in for a substantial and distinguished career at NYU and we appreciate very much your presence —

PROFESSOR ROY C. SMITH: [interposing] Thank you.

MR. LORNE: - on the panel, Roy. Next to Roy is Annemarie Tierney. Annemarie is General Counsel, Corporate Secretary

of SecondMarket, Inc. and includes in her background – she's been at SecondMarket for a couple of years now, I think – includes in her background time in the private practice of law and time at the New York Stock Exchange, now New York Stock Exchange Euronext, which is an extraordinarily useful background.

Next to Annemarie is Roberta Karmel. Roberta has been teaching for the last several years at Brooklyn Law School. Before that, she was a Commissioner of the SEC and made her initial claim to fame with a book that was important when she wrote it back then. She's heard me say this before and is grimacing already, but it is important again, in fact, which is *Regulation by Prosecution: The SEC Against Corporate America* and the whole question of the development of the law through the SEC and the Department of Justice in civil and criminal litigation rather than by the rulemaking process. That sort of process ebbs and flows, we see in history, but it's at a peak again right now.

We are going to, as I said, talk about the changes in the markets and their effect on the corporate world. It's a small enough group. I'll invite you to ask questions when and as questions may come to you. I'm afraid on my right, it's like the sign on the back of the trucks, if you can't see me, I can't see you? Or I guess if you can't see my mirror, I can't see you. You can't see me and I can't see you, so make a little noise if you want to ask a question.

PROFESSOR SMITH: They could move.

MR. LORNE: Or move or stand up or whatever makes sense. Why don't we start out and I'm going to invite the panel generally to discuss all of the questions rather than suffer from talking heads syndrome. But there have been an enormous number of changes in capital markets over the last several years and we can start just about anywhere, and I'm going to invite Sophia to address whatever aspects of it she wants to. And we can talk about high-frequency trade and we can talk about the Facebook experience and whether the Securities Act still works. Sophia, the changes you think are of significance?

MS. LEE: Sure. The markets have evolved a lot over the past decade, as you're all aware. Trading used to be concentrated on exchanges. Trading was done on lit pools and now

there's an emergence of other forms of liquidity, other venues to trade on. Liquidnet was formed basically to allow institutional investors to have a safe place to trade large blocks of stock, because the average order size on the New York Stock Exchange or the retail markets is about 250 shares. Large institutional investors, like pension funds and mutual funds, trade in the order of 200,000 shares. So in order for them to source a liquidity the way they used to trade would be to call their broker, who then called their brokers and their friends to get enough liquidity to trade these large blocks. Of course with every phone call, the price ran away from the trader. So they're incurring market impact costs along the way. So once you have these block order pools where they can trade anonymously and safely with each other, that saves money for the institutional investors, which ultimately benefits you and me, the people who invest in these mutual funds or have 401(k) plans. So I think there is a role for these alternative trading pools and there is a role for alternative venues other than the traditional exchange model that we're all familiar with.

There has been emergence of other types of trading, such as high-frequency trading. Long-term investors typically trade based on fundamentals and hold for the long term whereas high-frequency traders trade for the short term based on algorithms and not on the fundamentals. But I believe there is a place for high frequency traders as well. Exchanges and other venues cater to them and want their liquidity, but I think it's up to the institution to choose where to trade. So we can have places where there are HFTs and places where there are not HFTs and I think that's where places like block order pools come into place: to allow them the choice of where to trade.

MR. LORNE: Annemarie, do you want to talk about what's going on on the private side of trading markets? It's. . .everything has changed that as well.

MS. ANNEMARIE TIERNEY: Yeah, I would love to. Si touched on my background. I've been a public company securities lawyer for 20 years. My first job out of law school was at the SEC and then, as Si noted, I went into private practice and then the New York Stock Exchange. So really 18 years of taking companies public, talking to companies about how robust the U.S. marketplace was, and my previous employer before SecondMarket was a dark pool like Sophia's called Nifex, and so I've always been in the space. When I joined SecondMarket,

it was a little tech startup, some of you may never have heard of it, that wouldn't surprise me. But as I say to Roberta, my job is like a constant securities law exam. There is very little black and white in the secondary trading market. So just as some background, my company was founded in 2005 by a former bankruptcy investment banker who realized that there needed to be a better mechanism for finding liquidity for highly liquid assets. So we started trading restricted stock of public companies, we started trading securities when that market froze, so we still do a lot of fixed income. But in 2007 and 2008, we started getting phone calls from Facebook employees, former Facebook employees saying, "hey, you're finding liquidity for restricted stock, can you also find liquidity for private company stock?" And that's really what we're focused on right now is finding liquidity for private company stock pre-IPO. And we think being a public company is a very important thing for a company to accomplish, but I'm sure we'll talk a little bit about how the market has changed for public companies and all of the costs associated with that. Sophia touched on high-frequency trading, which is very negative for companies that are small or midcap, because there's not a lot of interest in their stock because they're not highly liquid. So our company sort of is in the space before a company goes public, and what we do is we work with companies and do what are called liquidity programs where former employees or current employees can sell in private placements to accredited investors in an efficient, controlled method. So it really is an interesting stepping stone towards becoming a public company and puts a lot more control over when a company goes public in a company's hands. So I think it's a really interesting space; there's a lot going on congressionally in the private company space. We might talk about that a little bit, too, but I think it's a really exciting time to be a securities lawyer in that space because there's so much going on.

MR. LORNE: Yeah. I'm not sure exciting is comfortable for me—

MS. TIERNEY: [interposing] Scary is a [inaudible].

MR. LORNE: -entirely. I liked it better when I knew all the rules, but—

MS. TIERNEY: [interposing] They're the same rules, they're just applied in a broader fashion.

MR. LORNE: I mean we had an experience during the summer in which Facebook was having another private placement round, Goldman Sachs is leading it and they decided halfway through the round, I take it, and I'm just reading between the lines in the newspaper, that the degree of publicity and everything else and the potential forthcoming public offering of Facebook made them all very nervous, so they cancelled the U.S. piece of it and did the whole thing overseas. Now, that says something about how well our regulatory apparatus is working. And Facebook obviously isn't typical.

MS. TIERNEY: Correct.

MR. LORNE: But it has to raise questions about whether the system is working. Roberta, what is your reaction to all of that?

PROFESSOR ROBERTA KARMEL: I think it does raise a lot of questions as to whether our regulatory system is working or our market structure is adequate. There are always a lot of contradictory themes in terms of the way in which the Securities and Exchange Commission is supposed to regulate public markets. It's supposed to encourage competition, it's supposed to integrate the markets so that all of these competitive venues, nevertheless, form an integrated national market system. And it is also supposed to assure that the markets are fair and orderly. I think we have a lot of competition now, but I'm not sure that these other values are really being met. And while I can certainly appreciate the desires of institutional investors to want to find liquidity in ways other than on the public securities markets, and the desires of private investors in private companies to want to find venues where they can trade their stock, so I don't want to say anything that puts down Sophia or Annemarie.

MS. TIERNEY: We've been friends for a long time; you say whatever you want.

PROFESSOR KARMEL: But I find the way in which the markets have evolved and the pass we're at today very disturbing. And I say that not only as a former regulator, but also as an individual investor. I don't think the market is terribly safe for individual investors. One of the problems is that there's insufficient interaction between institutional order flow and retail investor order flow. And I think that phenomenon like the flash crash is just, to me, kind of terrifying. And I think to a lot

of other investors who have really lost confidence in the public securities markets. And it's not only retail investors who've lost confidence, but actually others who don't even want— this symposium is supposed to be talking about the effect of all this on corporate governance. Issuers don't want to have their stocks traded in the public securities markets. I think that is a very dangerous trend. Very dangerous. Because the secondary markets are supposed to be there in order to assist in the capital formation process, because if investors could not resell their securities after they invest in companies, they wouldn't invest in the first place. And yet what is going on today primarily benefits those who are trading in those markets instead of public companies. So I may be very old-fashioned, I'm certainly influenced not only from my days as an SEC Commissioner when the Commission was early on implementing the provisions of the Securities Act Amendments of 1975, which put up the idea of a national market system, but I'm also influenced from my experiences on the board of the New York Stock Exchange in the 1980s. While that was hardly a perfect market, and there were a lot of problems with the stock exchange model, in many ways it did solve the problems we see today of fragmentation and problems with the price discovery mechanism, because orders were brought to one place and they interacted with one another. So I think the challenge for regulators is to figure out how, in this very different kind of marketplace, there can be mechanisms for compelling orders to interact with one another to benefit the price discovery process. I think that's enough for now. I'll say more later.

MR. LORNE: Roy, are you as troubled as Roberta with our ability to control what we've created?

PROFESSOR SMITH: Well, I suppose so. But I've been involved with these markets for a very long time and they've always been messy and sloppy and filled with people complaining about discovery or other mechanisms and so on. You know, financial theory holds that the shortcomings of corporate governance should be offset by the perceptions and the cleverness of institutional investors who will react to their mistakes and misjudgments and hype and whatever and kind of find the right price because they will benefit from having all the information that's available through transparency and such available to them. Yeah, that's a nice theory, nobody really believes it works in practice that way, although probably in,

over a period of time it sort of regresses to a mean of that sort. But the fact is that the markets have changed. Again, I mean not just in structural terms. We created the NASDAQ, we have globalization, we have a lot of different players in this thing. We've had deregulation of various types, including for allowing for Rule 144A that permits all this trading in private markets. But in the end what's happened is our investors aren't really in it for the long term. Today about 65% of all stocks in America are owned by institutional investors; they account for over 90% of the trading. They only crossed the 50% border in about 1996, so this is a comparatively new phenomenon. But you would say with all of this weight on their capabilities to judge stock prices correctly, that we shouldn't have the kinds of volatility and the embubblement of market that we've seen twice in the last decade occur. And yet it does. One reason for this is that there has been a huge increase in the amount of trading intensity that takes place in the U.S. markets. More so in the U.S. than in other markets. In 2000, which was sort of a beginning of the tracking period for this, we already had an annual turnover in stock trading that was equal to about twice the market cap of the year. So every stock traded twice during the year. It was much more intense at the NASDAQ than at the New York Stock Exchange. The NASDAQ was then trading around three times in a year and the Stock Exchange about 88%. But in the following decade big things happened. First of all, okay, if you haven't figured this out, Roberta's right, it's been a miserable decade for an investor. The Standard & Poor's Index is up 10% gross over the last 12 years. That is an insufficient amount of growth to make anybody satisfied with a portfolio of stocks. One of the consequences of this has been that large institutional investors, like pension funds and wealthy families and other endowments and other groups, have decided that they have to find a better way. They can't actually stay solvent with such low returns on their stock portfolios. Particularly with interest rates declining to the extent that they have. It really destroys all the equity in these pension funds, which we know would have happened. So they have moved into alternative assets in big ways. In the last decade about a trillion dollars has moved out of the public stock market into hedge funds, where it's still public markets to some degree, but it's there in a different context. Another

trillion has been added to private equity and a further trillion has gone into exchange-traded funds.

Now these are all efforts by ordinary institutional investors to try to improve their performance by moving into some other venue where the skills applied and such are going to be different and better. But the consequence—well, one consequence was that as of 2010 or so the trading volume intensity increased further. So now, you know, we traded something like $48 trillion of value traded in 2009, the last year for which I have these figures. That's 309% of market capitalization, up from 200% before. And that's a big increase in the trading volume from before. The NASDAQ turnover rose to 700% in 2009 and the New York Stock Exchange to 120%. So this is largely suggesting that the market is seeking different investment strategies which are much more short-term oriented than they were before. And this is the rub on the corporate governance. If the investors are only going to hold the stock for a few months, they don't care what goes on at the board of directors or what goes on in any other corporate government stuff. So we're actually, you know shouting into the wind when we complain about corporate governance because the investor base that's supposed to monitor this stuff just isn't involved with it long enough to really make it any difference to them.

Now this is less true for some hedge funds, which are activists and try to promote changes in corporate governance or management or whatever, but they're really a small part of the total hedge fund pool. Much of which goes after various forms of arbitrage or momentum strategies or different kinds of things like this. But the trading intensity is what's gotten away from us. Now how we deal in a regulatory environment is trying to both provide fair and well-disciplined markets one side and on the other side try to find some connection in corporate governance or just reinforce the corporate governance connections is a very difficult challenge. And, as hard as it is, it's even harder when the market keeps changing. It's not the same as it was when we finally figured out what the regulatory platform we want to have should be. You know, these things are driving us crazy because as soon as we got it figured out, it changes.

So I'll leave you there and I'll have some comments about the regulatory side of this later on if anybody wants to hear it.

But I thought I would just lay out some of these market factoids for you so we can struggle with them all together.

MR. LORNE: We had a question here.

AUDIENCE MEMBER: I found what you said very helpful about understanding the market. My question is how large is the secondary market? Are we talking—how—compared to the other market, the traditional market, how big is the secondary market? And, also, what's happening in Asia? Because those markets we often ignore. There's the Hang Seng, there's the Shanghai Exchange and there's now the Shenzhen Exchange and I feel that a lot of these exchanges are extremely important— that's okay. I just want to know about—I'll say it very briefly. I wanted to know about secondary markets. I appreciated the factoids. I'd like to know how large it is compared to the traditional market, you know, NASDAQ, New York Stock Exchange, that kind of thing. And then I wanted you to talk about the Asian markets and how they are impacting. Because it's now a choice of markets where you can go. So if you could comment on that, I'd appreciate it. Thank you.

PROFESSOR SMITH: Well, the secondary market generally means what is the value of the shares traded on all the different exchanges where secondary transactions occur.

MR. LORNE: But I think this question was also picking up Annemarie's business and the secondary market that you don't see.

MS. TIERNEY: So you're talking about pre-public or non-public trading—

AUDIENCE MEMBER: [interposing] Yes.

MS. TIERNEY: —versus public trading.

AUDIENCE MEMBER: Yes.

MS. TIERNEY: There's no way to measure how much pre-public or post-public trading there is because it happens in a variety of factored mechanisms. It happens through Millennium Partners buys a big block of stock directly from a company, from its shareholders. T. Rowe Price mutual funds. On SecondMarket last year we traded about $800 million in private company equity. That's not a very big number. Other players in the marketplace, you know, I just don't know. That's part of the problem is it's private. Companies have to file Form D's when they do a private placement under Reg. D,

that's one way to sort of see how they're doing capital fundraising. But it's really difficult to know what's going on in the private markets because there's no reason—we're not required to report that to FINRA. There's no, you know, [inaudible] trace or anything like that. So it's really hard to quantify that number, other than a best guess. But I would say probably, you know, billions of dollars. Easily.

PROFESSOR SMITH: Maybe more than that. The New York Times had an estimate last September of 12% of the total volume of trading is done in dark pools.

MS. TIERNEY: But we're not talking about dark pools. Because dark pools are publicly traded securities, this is all private stocks.

PROFESSOR SMITH: Okay. Well, that would be less.

MS. TIERNEY: This is a company that's not registered.

AUDIENCE MEMBER: Well what about Asia?

MS. TIERNEY: I mean my experience from when I was at the New York Stock Exchange, part of what my focus was, was international listings and I know that, you know – and other people have more experience than I do – Asia has a huge amount of traction for a lot of reasons. There's a lot of capital there. The U.S. is perceived to be a very expensive and libelous place to register. One of the things I did when I was at the SEC a million years ago was I had to track the number of international companies that were listing on various stock exchanges around the world, and the U.S. lines were always like this. And I left in '96, and now the lines are like this. So I think that what you're finding are very dark pools of capital, a lot of asset managers in Asia that have a lot of money to spend, a lot of companies in China who are looking for investors who are now not willing to come to the U.S. because of the negative publicity around Chinese companies in the U.S. So I don't know that we can quantify that, or I can't quantify that. But I think that, you know, the preeminence of the U.S. as a capital market, public platform, has definitely shifted in the last 10 to 12 years.

PROFESSOR KARMEL: I believe that in the last two years there have been at least as much, and, in one of those years, more IPOs in Hong Kong than in New York. So why is that? I was in Hong Kong actually in December, it's a very lively place, everything seems to be booming, but, you know, why do you

have IPOs going there? I think one reason is the capital is there. That's one reason. And not all of these IPOs are of U.S. companies. I mean, my own opinion is that a lot of the problems in the stock markets reflect problems in the real economy. Why has investing these been such a poor—given such a poor return in the last decade? Well, the real economy has been declining. So I don't think we can solve the problems in the stock markets unless we solve problems in the real economy. That phrase "real economy" is kind of peculiar, but I guess everybody knows what is meant by that.

PROFESSOR SMITH: Well, I can give you little factoids about Asia and IPOs. There have been more Asian listings than American listings in part because American companies haven't been going public. There are a few non-Asian companies that have listed in Hong Kong, like Glencore, which is a commodities firm that came out last summer with a $10 billion IPO. It was listed there and on London at the same time. A great deal of the securities that are being listed on the Hong Kong exchanges are actually sold in Europe and in America through private placement transactions— 144A and so on. Maybe as much as half of those are sold outside of Asia. The Asia listing component is attractive because it's cheap, and it doesn't have the SEC scrutiny that we have here. And it doesn't have the litigation consequences that exist. So why not go there if you don't want to do all that? Now the trading market that evolved from it is generally inferior to the ones that we have in the United States. The volumes in the secondary markets are less intense. The trading there is much weaker than it is here, so you have a tradeoff. If you don't care about the trading market so much, you might go there.

MR. LORNE: It's also fairly artificial to talk about these as separate markets. And this goes to Jerry's comment, the globalization piece of it. Roy's exactly right that when you have the offering in Hong Kong, a lot of it gets sold in Europe and in the United States. When Goldman Sachs decides it can't offer the Facebook shares privately in the United States and it goes to Hong Kong, who's buying it in Hong Kong? My firm is. We've got an office in Hong Kong. Goldman Sachs is offering it in Hong Kong. In what sense is that a foreign transaction? We tend to think of it in a geographically constricted mind frame, which is the way the regulatory structure is set up. That just doesn't make any sense. I mean why do we care when

Goldman Sachs sells shares to Millennium whether the transaction takes place in New York, London or Hong Kong? Go ahead, Sophia.

Ms. LEE: I think Si makes a very good point. At Liquidnet we trade securities in 39 markets all over the world that includes Hong Kong, Australia, you know, UK, France, et cetera. And, you know, regulators like [inaudible] are trying to set forth standards for market structure in terms of transparency, disclosure. And I think the difference is that each market is at such a different place that it's hard for them to set the rules that will apply globally. But I think that, as long as each entity follows the standards, there should be some sort of passporting. So, for example, they have that in the EU where if you comply with the UK FSA's rules, they allow you passport into other jurisdictions. So I think in terms of globalization, you know, the U.S., as Annemarie pointed out, is ahead of some of the other countries in terms of the amount of alternative venues that are popping up. For example, in Australia, for a long time, there was only one market, you could only trade on the ASX. And not until last year did they finally pass a rule allowing alternative marketplaces to exist even. And I think because of this disparity, I think the rules do have to change accordingly. I think the rules in the U.S. are very outdated in terms of capital raising. There's been a lot of advancement in terms of trading new venues, you know, making things more electronic, using [inaudible]. But in terms of capital raising, there's been little change in the way we do IPOs and the way companies raise money. Rules like 10b-18, which provide a safe harbor, for example, for issuers to go out in the open markets to buy back shares, was passed in 1982 so that they can do this in an easy way without fear of charges of market manipulation. Yet that rule is so outdated because it requires a certain manner of volume price limitations, such as how does it trade above the last sale best bid. Now in today's markets, because everyone's trading electronically, there are many times where, for example, midpoint price would be above the last sale and violate this rule, yet being at the midpoint is actually a safer way to trade because traders can watch the trading pattern throughout the day and say, "Oh, it was above the last sale" and realize there's an issuer, a big buyer out there and trader gets that big buyer. So I think, you know, the SEC has a ways to go in terms of making these rules more aligned with today's

environment in terms of trading, and I think they're just really bogged down with all the proposals that are out there, and they're really busy with different legislations that they propose a rule to do this in 2010, yet we have yet to see when they'll get passed.

PROFESSOR SMITH: Yeah.

AUDIENCE MEMBER: Well, I'd like to propose a question to Karmel. I don't want to hear about the SecondMarket, but my question has to do with—

PROFESSOR SMITH: [interposing] Go ahead, pick on her.

AUDIENCE MEMBER: Right. So my question has to do with both Simon's question and the Facebook conundrum, which is why do we care whether the transaction takes place in Hong Kong? Because there are rules that say that you can't do certain kinds of transactions in certain ways in the United States, and that's why we care that it's not taking place in the United States. So my question then is where is the line? At what point have we essentially made a company public and we're going through all kinds of generations to avoid the fact that they don't want to officially go public through the IPO process, and then we facilitate it through things like SecondMarket?

Ms. TIERNEY: Well, I think, if I, if you don't mind, I think it's really important to understand that all of the companies that we work with are subject to all of the parameters of the 33 Act. So all of the sellers on our market are selling pursuant to 144 or 4(1-1/2) inside the parameters of those exemptions or case, you know, statutory concepts that have existed for decades. This is not new. It's just more focused and more centralized, that's all, for better pricing for the seller. The vast majority of sellers in our market are former employees of startups, companies are—the—I only have one factoid, your factoids are much better than mine, but I've got just one, and it might be wrong, so you can correct—

PROFESSOR SMITH: [interposing] We don't care if it's wrong.

Ms. TIERNEY: No, I love this stuff. That 10 or 12 years ago a successful startup, from startup to IPO, was 4 to 5 years. And so most of you know that, you know, employees like myself in a private company, a lot of my compensation is in options. Options vest after four years. So employees of these startups were getting liquidity for their compensation options within four to

five years from the time that they joined the company, and there wasn't a lot of pressure. Now because of things like regulatory costs, high-frequency trading, the fact that for a company under about a billion dollar market capitalization, it's almost impossible to find somebody who will write research about your company. So being a public company today, the smaller, under a billion dollar market cap is not a place that a lot of public companies think is in the best interest of their shareholders because of the cost associated with being a public company, but none of the benefits. So all that we're doing is allowing sellers who have an ability to sell, to sell to accredited investors under a line of no action letters that have existed since 1996. So we're not— this is not some crazy, you know, out of the box thing. We are a registered broker-dealer. We are examined by FINRA on an annual basis. We are an SEC registered alternative trading system. You know, we are an extraordinarily regulated broker-dealer. So this is not happening in a vacuum, we're not doing 144A transactions, we're doing purely 144 and 4(1-1/2) in conjunction with companies. And I think that companies have, you know, one of the reasons that we're seeing some traction is that companies are subject to the 500 shareholder threshold. And I think one thing that was very surprising to me when I joined a private company coming out of the New York Stock Exchange and Nifex is for all of you that are familiar with the concept of when you have to become a registered public company, it's when you've had more than 500 holders of record at year-end and you're over $10 million asset test.

There's also a concept of beneficial ownership under the '33 Act where you have to sort of look through certain entities to decide how many beneficial holders you have. In the private company markets, almost without exception, your number of holders of records is exactly the same as your beneficial holder number. There's no trust to look through; there's no street name. Private company stock is not DTC-registered; it's not traded through DTC. So if I have 85 names on my stock registry, I probably have 85 beneficial holders. All of these companies are very conscious of the 500 shareholder threshold, and they want to make sure they know who their holders are. So this is not, you know, regulatory; I mean I'm a regulator. I'm a regulator at heart. I drive my business guys, my CEO crazy every day. Well, if I was still at the SEC I would say this "like

you're not." But, you know, that's the way you have to think of these markets. And I think that one other thing I'd note is that what came out of the Goldman-Facebook situation was very interesting to my company because we had been talking to Congress, different members of the House and Senate, starting back in the summer of 2010 about the 500 shareholder threshold. And how that actually puts downward pressure on job creation for private companies because they're not hiring employees the way they might want to because they're worried about the 500 shareholder number. Or they're not acquiring other companies to grow their business because they don't want to take on those shareholders and push themselves towards the 500. So we were talking to different members of Congress about increasing that number to a different number. That number dates back to 1964, which is the year of my birth, and thus a great year, but, you know, it's a while ago. So one of the things that happened as a result of Goldman Sachs was that members of Congress kept saying, "Well why do we care about a rule that only lets rich people buy Facebook stock?" And it's always about Facebook. What other people don't think about is there are thousands of other private companies behind Facebook that are sizeable, successful, and have a lot of employees, but are not ready to go public. When Facebook happened, my CEO said, "Should we stop talking? Should we stop pushing this?" And I said, "I honestly think this is a pivotal moment," and, in fact, it was because the conversation went from, "Why do we care about a rule that only lets rich people buy Facebook stock?" to "What do you mean Americans can't buy Facebook stock?" So in one way it was a very pivotal moment for Congress. And what you've seen is a raft of legislation in the past six to eight months that would really change the way private placements happen in America. There's a bill that would change—the bill that we've been supporting would help private companies increase the 500 shareholder number to a thousand, but excludes employees and former employees from being counted towards that number because those are people who have already been deemed not to require the protections of registration by the SEC. There's a bill that would eliminate the general solicitation prohibition in the context of private placements because who cares if retail people know about an offering if they can't participate unless they're ac-

credited. There's a crowdfunding bill that I know Si has some strong views on, that would allow little private companies—

PROFESSOR SMITH: [interposing] Not strong views. It's just a stupid bill, go ahead. Sorry.

MS. TIERNEY: It's not my bill. It's not my bill, so I don't— that's a bill that would allow private companies to raise up to $1 to $2 million from any retail investor in the U.S. in a, you know, without being able to generally solicit, that would stand things on its head. And another bill that would increase the thresholds for Reg. A, which is a small issuer-raising exemption that very few people use right now because you still have to register in every state. So there's a huge amount going on in Congress that will really change the way that private companies become public and how private companies raise capital. That's the part I actually think is exciting in a regulatorily conservative SEC happy kind of way.

PROFESSOR KARMEL: If I can really say something on a different kind of level than what Annemarie's talking about, and it's a little bit in response to your question – why do we care? I think we care because we do industrial policy in this country in some very strange ways. And one of them is through the Securities Exchange Act of 1934. So a lot of the corporate governance provisions of the Securities Exchange Act of 1934, particularly those added by Sarbanes Oxley, Dodd-Frank, in this century, are not actually suitable to smaller companies, and they really don't— I mean, in my opinion, they don't have that much directly to do with investor protection, but it's one of the ways that Congress enforces certain ideas about accountability of large public companies. And so I believe that some of the reforms that Annemarie just described that are going on in Congress, is really the wrong way to go about fixing the system. It seems to me we should just have '34 Act requirements in terms not only of disclosure, but also of corporate governance that don't apply to all public companies— that don't apply to smaller public companies. I think this would be a much better way to fix the system instead of trying to go back to deregulation. I don't think deregulation of the financial markets had a very happy ending in 2008. And I don't think we should go back to that technique for dealing with what are very real problems.

MS. TIERNEY: I agree.

Ms. LEE: And I think I agree with Roberta because even though, as Roy pointed out, there has been an increase in the amount of volume in trading, market volume's actually been very concentrated over the past few years. Because if you look at block trading, the top ten names have accounted for about 50% of this block volume. For example, you know, Citigroup itself was about 18% of all block trading last year. So I think there is a problem with the liquidity for these smaller companies, and I think there needs to be venues like blocks and other alternative venues in order for them to get the liquidity that they need. And as Roberta mentioned earlier, she wanted to see linkages to allow retail flow to interact with this flow, and I think that is also very important to make sure that the flow can be interacted with. And there are safe ways to do that, and these pools are meant to address that factor. Fragmentation is really competition, which is encouraged by the government and every other industry other than ours, and I'm not really sure why that's so. But having these alternative venues will help these small companies raise capital and put these companies directly in touch with these institutional investors that are really the core, long-term constituents that they're most interested in, in terms of corporate governance as well.

PROFESSOR SMITH: Yeah. I'm not so sure that's going to happen. It's true; it has been true for a long time that the bulk of the trading volumes occur in the largest stocks. Largest stocks have room for large investors to buy positions that they will find liquid, they can turn over quickly, and so forth. And when you get into smaller situations, you lose some of that. But we have had a—we have a basic problem with raising money for smaller companies. Part of it is getting information out to people about the companies that investors are solicited for, information that is of an SEC quality. And we have trouble getting research following in the aftermarkets once these things do start up. We have a rather sad history of bringing companies to the public market through IPOs, and then a year or so later they sort of poop out and disappear. There's very little trading in them and so on. If large Wall Street analysts don't follow these companies and write research reports on them, and if the companies don't have a sufficient amount of float available to trade on, then they just aren't going to get the interest of the large institutional investors. And then you get to the question, "How do you make a business of getting mom

and pop investors, or small investors, to fill this gap?" It's good that we have different ways to do this. I think 144, 144A, these other mechanisms that come along are efforts to help. And they may be more helpful to the companies in the middle rather than the smaller ones. But I think essentially we have to be careful at the same time we don't create ways in which we can farm off stock without any information disclosure, simply because it's considered to be exempt from various rules because it's a small company and doesn't have to and so on. The idea that, you know, you can go on a computer, go on a website and get the names of a whole bunch of companies looking for money, and you just send them a check sounds to me to be a rather backward way to do this. But I don't think it's going to solve the problems of raising money for these companies in the long run. You know, some stuff has to be done with basic fundamentals. Companies should not go public until they're ready to do so. That means that they have to be economically viable to a reasonable degree. They have to have a degree of infrastructure support that enables them to sustain the burdens of being a public company, and that usually means they have to be more mature than they were in the days when you were talking about, Annemarie, you know, four years from beginning to IPO. That isn't the case now; it's taking closer to ten years for that to happen, which is the way it was before. I think it takes a while for companies to get to be public.

MR. LORNE: Yeah. And I'm going to disagree and agree with something Roberta said. I think it's terribly unfair, Roberta, to say financial deregulation didn't work out very well in 2008. Whatever financial deregulation we had, had very little to do with the problems of 2008. Now, that said, it—

PROFESSOR KARMEL: [interposing] [chuckles] I don't think so at all.

MR. LORNE: Well—

PROFESSOR SMITH: [interposing] Well, leaving apart the fact you let the banks come in there and [chuckles]

MR. LORNE: [interposing] We've debated this—

PROFESSOR KARMEL: [interposing] That's a very different argument than the one that—than the topic that we're addressing today.

MR. LORNE: We've debated this before and we'll debate it again, but we don't need to debate it here. The question is, I

think, whether the evolution of Sophia's and Annemarie's businesses suggests that the regulatory framework we have right now doesn't really fit the facts very well. And I think we can—and then we can agree that's true. And then the question is what do we move to and how do we get there and who does it. And part of what's come out is that in a global world, that's a very different question than it was in 1932 to '34. We can no longer say we will set these rules for transactions within the United States when the vast majority of the transactors have the ability to do it outside the United States as easily as inside. And, Annemarie, I take it your business is easily outside the United States, or inside?

Ms. TIERNEY: No, right now we're purely in the U.S.

MR. LORNE: I shouldn't have said that then. [chuckles]

Ms. TIERNEY: No. No. But we were looking at different things. We're looking at Asia, we're looking at Europe. Those are all markets that are very interesting. When you look at Asia, you know, one of the things that we have to worry about is who the companies are and how do you do the diligence around getting comfortable with them. Our company has only been in the private company space full-on for three years. I think we're trying to get it 100% right in the U.S. before we expand internationally. But when I joined, it was like how about Brazil? How about Europe? How about Asia? And I'm like, "Oh my goodness, how about New York and California, and we understand blue sky before we start selling, you know, Mongolia?"

MR. LORNE: Sophia's business certainly is around the world, and Roberta is legitimately concerned. I want to come back to, I thought, a point of disagreement between Sophia and Roberta earlier on and that is the visibility, or lack of visibility, of your markets and the relationship, or lack of relationship, between your markets and the publicly available markets.

Ms. LEE: I think Mary Shapiro herself said, in one of her speeches, that not all dark pools are created equal. There are a lot of dark pools today that do have high-frequency trading and the order size in those markets are the same as that on the New York Stock Exchange, about 250 shares. So those are truly retail sized venues. Yet there are other pools, which are more block size, like ours which average execution size is 50,000 shares. So I think, you know, in any marketplace, you go out,

you buy, you know, napkins or food, there's always a wholesale market and a retail market and I think that should be the place for equities as well. If you have 200,000 shares of a stock you need to buy, you're not going to go on the New York Stock Exchange to buy because that liquidity does not exist. There's an imbalance. And I think, yes, the retail investors also need to access that liquidity, and there are safe ways of doing so. There are systems out there that allow retail flow to interact with institutional flow as well. For example, one of our alternative trading systems does permit retail flow, which comes from ECNs, exchanges and other broker/dealers, to send that flow to match directly with institutional flow as well, where they basically aggregate the smaller retail orders and cross with the larger block size order. So I think there are linkages out there that do that. The exchanges have come up with job trading platforms as well that do that. And I think those linkages are important and do address the concerns that Roberta pointed out.

MR. LORNE: Now the high-frequency trading tends to be in smaller size obviously and we didn't talk very much about the implications of high-frequency trading, but, Roy, you touched on it, obviously an element of high-frequency trading is the very short duration. P.S., we can't all agree on high-frequency trading; our firm takes the view that we don't particularly engage in high-frequency trading, but we do have about two million transactions a day, which some would think was frequent. But we aren't as concerned with the ultralow latency and the development of ways to get information from, you know, Chicago to New York that shaves a nanosecond off to facilitate getting the order in before the next guy. But what about the corporate governance implications? Roy, you touched on that, and we've had, at the same time as all of these developments, we've had an environment in which there have been efforts to democratize, if that's the right word, the corporate governance environment to enhance shareholder voting rights. We've talked about proxy access. Never mind the SEC's failed attempt at getting there, but Dodd-Frank clearly had a congressional endorsement of a more democratic process. But how do you do that in an environment where a lot of the shares, let's call it 30-40% of the shares, are people who don't care about corporate governance? Roy, what—

PROFESSOR SMITH: [interposing] Well, that was my first point, and this disease is getting worse because we have an increasing amount of trading activity that isn't really based on any sort of valuation of the long-term value of a company, just simply looking at trading anomalies that are exploitable. And now even more so exploitable through this extraordinary technology that has permitted very frequent trading. I understand, though, that there are disputes as to how much liquidity it actually provides as a boost in liquidity. A great many of the orders put in are never executed because they are sort of a shotgun approach, only one or so little pellets gets the hit and the rest go off into the void. Only about 400 stocks seem to be eligible for this kind of high-frequency trading, out of 5,000 or so that are listed on the Stock Exchange and NASDAQ. So, you know, it's hard to see that it has any corporate governance implications at all. It does make it complicated though for institutions acting as fiduciaries for their investors who rely upon the fiduciaries to vote the shares that they own. Now, if I'm a fiduciary for a hedge fund that is trading, you know, like two million shares a day—

MR. LORNE: [interposing] Two million trades.

PROFESSOR SMITH: Two million trades a day. Sorry. Two million trades a day. Only am I, somehow or another, you know, losing track of my ability to actually sit down and vote those shares in a responsible way. I suppose that most of people who would invest in such fiduciaries don't care about the voting at all. They want to see that the anomalies that the trading opportunities permit are pursued profitably. That's all they care about. This is taking up a substantial portion of our total trading now. It's hard to know exactly how much, but, you know, it was interesting. I was listening yesterday to Tom Keene on the Bloomberg Surveillance Show, he's in Davos of course, talking to all the important people. While those of us who don't go to Davos are listening to him. And he had a hedge fund guy on there and the hedge fund fellow was saying that these are very difficult markets and hard to know what to do. So he thought that they should go back to, you know, good, old-fashioned value investing, and Tom said, "You mean buy-and-hold." He says, "Yeah, I think we should go back to buy-and-hold." And he said, "You know, you're the first guy on this show in three years that has had anything good to say about buy-and-hold strategies." And then he said, "Yeah, I

know, buy-and-hold's the way it's going to be." He says, "Well, how long do you hold when you buy and hold?" "Oh, about six months." So it's not clear that we're ever going to get back to a kind of, you know, Warren Buffet-style of plan to own it for four or five years or more when you buy into a position, which, in turn, has corporate governance implications. I suspect that the market has essentially lost interest in corporate governance and whatever the SEC does, whatever the voting rules are, they've simply lost interest and they aren't going to be cutting-edge influence. And that's very discouraging to people who like to think that the market is supposed to provide this governing effect or this restraining effect on corporate management. Now it has to come from probably somewhere else. It may mainly be coming from litigation exposures rather than from governance directly.

PROFESSOR KARMEL: So I think that does raise a very fundamental question about the SEC's idea and the corporate governance provisions that are in the Exchange Act as to whether this is the way we should make public corporations accountable when you have two second investors who may have a say in who becomes directors of the corporation.

MR. LORNE: Only if they happen to still own it at the close of business. [chuckles]

MS. TIERNEY: Right.

PROFESSOR KARMEL: I think we have to go to some other model altogether for corporate accountability because I think the whole idea of shareholders being the owners of corporations hasn't made sense for a very long time for public corporations and really doesn't make any sense whatsoever today.

MR. LORNE: In some circumstances. And yet in the activist investor circumstance, in the Pershing Square kind of circumstance, it does make sense. And it's hard to tell which is which in the abstract.

PROFESSOR KARMEL: In the abstract, yes. But, I mean, you know, these are very serious issues— who should be running the giant corporations today that have such a huge impact on the economy, on unemployment, and who should be able to weigh in on that decision? And the idea that it should be investors in the stock market has become very troublesome, given the state of our markets.

MR. LORNE: But who else would you turn to?

PROFESSOR KARMEL: Well, this is what—

PROFESSOR SMITH: [interposing] Well, the alternative is the government. And that is the scary part.

PROFESSOR KARMEL: Right.

MR. LORNE: Yeah. Right.

PROFESSOR SMITH: And we don't want the government to do that because the government will be ten years behind where it ought to be in trying to do these things.

MR. LORNE: However bad investors, like my firm, are—the government would be worse.

PROFESSOR SMITH: Yeah. Yeah, we don't want the government to do this.

MR. LORNE: George?

GIORGOS STAMATOPOLOUS: It seems to me that this situation that Professor Smith is describing with a shortening of holding periods is somewhat irreversible, given the volatility that new ways of circulating information has caused for stocks. So if this situation is irreversible, is it possible, perhaps, vis-à-vis corporate governance to adopt models of, let's say, other countries such as Germany where we see workers, for instance, unions playing a big part in corporate governance? And couldn't that be an alternative to the government having an active role? One where the incentives of all the players are sort of aligned and have a longer view toward growth of an individual company or the economy itself?

PROFESSOR SMITH: Well, the central question there is what is the role of the board of directors. And you can put the unions on the board of directors if you want, or not, but are we relying on the board of directors to be the cutting edge of corporate governance? And that really is the way we do it in the United States. And we hold the board of directors responsible for certain fiduciary activities, and, you know, they're all incorporated in Delaware, so the Delaware Chancery Court sets forth an illuminated path of how you can behave in certain ways. And that seems to work well enough. But we have plenty of people who think that corporate directors on the whole have been sort of taken over by management or influenced by management, or the sociology of boards is such that the directors tend to be stuffed animals more so than activists. There's truth to this, of course, as we know. There are others who fight it back somewhat more. But, you know, it's still private prop-

erty. So who's changing this? Is the government going to change the rules as to who should be on the boards? Should we mandate that labor unions go on there? Or the Governor of New Jersey or someone like that? I mean they have these kinds of situations in Germany. There's been no evidence that German corporate governance has resulted in better corporate performance than we have here. So, you know, just going to be probably that the directorship as the last bastion of corporate governance is probably the best we're going to have. And maybe we should start to ask ourselves whether it actually doesn't do the job reasonably well and not have to mess around with it too much more.

Ms. LEE: I think as Roy pointed out, the directors are the ones that kind of oversee the management, but the board, as you recall, is elected by the shareholders of the company. So I think there are plenty of shareholders around who are—

PROFESSOR SMITH: [interposing] After the nominating committee has put up the—

Ms. LEE: [interposing] That's right.

PROFESSOR SMITH: And then these fiduciary for funds and investors fill out their voting cards and send them in. Now how they do that is another issue. Sometimes they just, you know, follow the advice of some advisor, but there's not a lot of individual scrutiny on that.

Ms. LEE: I agree there could be some changes made in terms of how the proxies are made and how the voting is done in terms of the process, and I think that the shareholders still should retain the right to make these decisions because it's their value that they're voting upon, and there are long-term shareholders out there still, which are these institutions that buy and hold. High-frequency traders, as Si pointed out, I think, at the end of the day usually ends up flat for the day. So if they're not on the book of records by the end of the day, they don't get a vote. So I think as long as the long-term investors who are really the core constituents of these companies have a say, they will vote for the best interest of the shareholders.

MR. LORNE: But that gets into a whole different way in which the whole system is broken. And that is the whole stock lending phenomenon that's gone along with the increase in short sales activities, that's gone along with the impact of

hedge funds and what happens there, if you pay attention to it. I'm sitting there as a retail shareholder in IBM, and I own a hundred shares because my brokerage account from, let's say, Merrill Lynch says so. And it's in a margin account, and that gives Merrill Lynch the right to lend out the shares, and they lend out the shares, and somebody sells them short, and somebody else buys them. And whoever bought them thinks he owns a hundred shares. And his brokerage statement says he owns a hundred shares, and mine says I own a hundred shares. And the fact is there are only a hundred shares out there. And that problem explodes out so that we have no real idea what the real ownership outstanding is because Merrill Lynch never told me they loaned my shares for the short sale. And, in fact, Merrill Lynch in the ordinary course has ten million shares sitting there and only seven million of their shares want to vote, so let those seven million votes go. And if 14 million people show up and want to vote, they prorate it, but there isn't any tracing between actual beneficial ownership. And when you look at that, plus the high-frequency traders and everything else, don't you get forced to the conclusion that the whole system by which we pretend that shareholders are electing directors is really fundamentally even more broken than the securities laws?

PROFESSOR KARMEL: I like your word "pretend." I think that's exactly the right description of what's going on.

MR. LORNE: Yeah. And yet we keep putting more and more pressure on it because we want to have some check on the board of directors, and we can't see anywhere else to put the check.

MS. TIERNEY: Well, one of the things that we worked on when I was at the New York Stock Exchange, we had a proxy advisory committee, and it spent a huge amount of time trying to understand all these issues. So, how are shares held? Who should be voting them? How do you solve for things like, you know, short sales, and the fact you technically own the shares, but somebody else thinks they owns the shares? I don't know that there's a way to solve the problem. I mean, one of the most significant problems that we had as a public company—You know, New York merged several times when I was there, and you have to have a shareholder meeting to approve the merger. Who owns your stock? So you have the whole other big problem in the shared planet that we all live in, which is

the fact that when you open a brokerage account, you may not even realize the fact that almost always the default is that the broker will not reveal your identity to the company. It's called an objecting beneficial owner. You have to often check a box that says I don't object in order for the company to know who the shareholders are sort of behind the broker. So it's this whole [inaudible] problem that really creates a huge frustration for public companies because if they—as we—I was also on the team at the New York Stock Exchange who helped write the corporate governance rules and interpreted them, and it was a huge problem for public companies because one of the things that we changed was that the shareholders themselves had to vote for things like equity comp plans. So you could no longer have the broker vote on instructed proxies. How do you get people who don't care about the company, they don't even care who the directors are, to care about things like getting an equity comp plan passed or other things? They've changed a lot of other "Broker May Vote" things very recently. So it's a real tension. I know the SEC's spent a lot of time thinking about that. We saw that the court struck down what they came up with, and the NYAC's spending a lot of time as well. But if retail investors don't care who's running the companies, they're the ones with the, generally, the longest-term hold positions. Most retail investors are not day trading, or maybe they're still really interested in dividends, but I don't know how you solve the problem. But there are so many things that don't work. There are so many reasons that U.S. retail investors are not actually stepping up to the plate and acknowledging themselves that they're owners of these companies and I think that's important. It's easy to look at institutions and say they're not doing things right or public companies aren't doing things right, but there are a significant chunk of retail investors in most public companies that are doing absolutely nothing to make sure the company's being run the right way. And I don't know how you solve for that.

MR. LORNE: By the way, you will find out as we go on, that we're going to raise a lot of questions, but we aren't going to solve very many. I'm hearing more concerns than solutions. Roberta, you touched on the flash crash in your earlier comments, and let's spend a little bit more time on the flash crash and what that portends and suggests. And, Sophia, it seems to

me, you need to be paying attention, you did pay attention, to that and worry about it as well. Roberta, what's. . .

PROFESSOR KARMEL: Well, I think that the flash crash destroyed a notion that stocks are based on any kind of value, at least within that one day, May 6th, 2010, because companies that certainly are viable companies dropped in price to almost nothing. To almost nothing. Procter & Gamble, Accenture, several others trading at pennies for a short time. Now, I feel we just really cannot tolerate that kind of extreme volatility because it does destroy investor confidence in the markets. I think what can be done about it—I am fortunately not at the SEC right now, so I don't have to figure out what can be done about it, but one of the problems is that the SEC didn't even have the information to come out with any kind of a report on the flash crash for, what, six months, something like that. So they have suggested a consolidated audit trail that is going to be maintained by the exchanges and other market venues and FINRA. They're not even going to have ownership of that, and, if they did, would they be able to analyze the trading and understand it and figure out what has to be done? I thought it was interesting—Si and I actually were both at a talk last night by the director of the Division of Trading and Markets of the SEC who talked about when you had triggering events in single stocks because of the circuit breakers that have been put in. And many of them are due to mistakes in inputting a trade and other rather odd phenomena that really should not be able to drive market prices to great extremes the way they do. So, again, I think part of the answer is transparency, part of the answer is some kind of a forced interaction of trading, and probably various kinds of market pauses. And I think one of the problems Roy touched on, which is that you have so many of these orders that are put in and then immediately withdrawn. Some people say if there was some kind of a tax on those orders, you wouldn't have that phenomenon anymore. I know most people on Wall Street are violently opposed to any kind of a transaction tax, but actually I have a family member who's in the securities business who deals primarily with retail investors who thinks a transaction tax would be a good idea; that it would cut into some of the volatility. I really don't think we have any data that would suggest what kind of an effect this would have on the markets, but it seems to me that we have to

try and figure out how to mitigate this extreme volatility. I think it's very dangerous.

PROFESSOR SMITH: I think the flash crash was probably a technical malfunction and if I were a regulator, I would wait for it to happen again before I thought it was a big problem to deal with. And if it does, it means that either that type of trading, if it results in executions of completely wrong prices that aren't withdrawn and restructured, which is probably what happens, I mean, we can get through that. The worst part of the volatility, to me, is the ability of markets to go through exposures like we did last year and worse, in 2008, when the average volatility of the U.S. stock market, somewhere around 15 to 20% in normal times. In 2008 it achieved a level of over 80%. And in three or four times since then we have had periods when it was over 40%. And, you know, we've had experiences last year when it was over 40% in which, you know, stock prices moved by very large amounts, you know, from one day to the next without any apparent reason for it to do so. But these are legitimate responses by investors who buy and sell because they think they have a reason for expecting the market to change in some way. But these levels of volatility are, in the end, going to destroy investor interest and are going to have longer-term consequences. Now, we're not in the business of trying to regulate volatility in markets exactly, but, you know, markets are supposed to correct themselves and then make adjustments for things that get out of whack, as these do. And I suspect that probably there will be some hidden hand, some invisible hand out there that will steer us towards a more sane approach in the near term. But with all the money involved in trading and the market values in the world, you know the market cap of the entire world, that is to say the bonds, tradable bank loans, stocks and the market value derivatives, at the end of 2010 was $212 trillion, up from about 80 trillion ten years before. So what we have is an incredible amount of money moving into markets that previously had been stashed in balance sheets of banks or insurance companies or things like that. And more money being created by a new valuation of new IPOs or global, China does better, more Chinese stocks come out, more privatizations, this number goes higher and higher. You know, this is a vast amount of money that is set up to be tradable across our globe, you know, we represent about 40% of that in the U.S., but all that out there can create, you

know, opportunities, but it also can create incredible liquidity storms when you get too much liquidity, it just floods over you and then you have none at other times. It could be a very disruptive way to do it. Technology has made it worse by making it easy to transact these things instantly from any part of the world, but we can't fight against technology, it's going to be there anyway. We're just going to have to hope that this system becomes more manageable than it has so far.

PROFESSOR KARMEL: I don't think the idea of waiting for another flash crash and hoping everything turns out okay is really the way to go.

PROFESSOR SMITH: I think it was a mistake. Now, if it wasn't a mistake, it will reappear. If it was, probably it won't.

MS. LEE: I agree with Roy that I think regulators should be prudent in terms of making regulations based on one single market event. The flash crash that occurred on May 6th, 2010 was due to a big imbalance between supply and demand liquidity and reading the SEC, CFTC study, you know, there was no smoking gun identified as the cause except there were a lot of issues such as stub quotes, market makers. There's a differentiation between exchanges and how they handle intraday trading halts. So I think the SEC has done a good job of doing away with stub quotes, which will take away that problem. Also, market orders— now limits are put in to make sure that those are not traded away at the prices that they were unintended to. And I think that, you know, regulators are wise to kind of stay back and watch to make sure that this is not a one-time occurrence. And I think the rules that they've passed through the circuit breakers and the elimination of stub quotes have done their job.

MR. LORNE: I think the stub quote question still isn't quite clear. They've taken away the extreme stub quote, if you will, and now you have smaller stub quotes. But you still have stub quotes sitting out there.

MS. LEE: Right.

MR. LORNE: But in a liquidity crisis they're going to get hit and people are going to decide whether that was a real order or was clearly erroneous.

MS. LEE: And I think they're trying to, you know, put the HFTs and regulate them as market makers as well to try to require them to put up two-sided quotes. But, you know, even

if they do that, they're going to be in their own business of trying to make a profit. I think it's going to be hard to force them to put it at a price that they're not willing to, based on the market at the time.

MR. LORNE: Annemarie, you touched on crowdfunding and we didn't get back to it, and I made a snide comment, which I probably shouldn't have. Why don't you talk a little bit more about it? There was a big article in the New York Times yesterday in the technology section talking about borderline crowdfunding.

MS. TIERNEY: So, first of all, my company doesn't do crowdfunding. We don't do primary at all. Right now we only do secondary, but a lot of the companies that we interact with, you know, went through this process as they were growing. Because of the crowdfunding generally had been that if you are—this is how most people start their businesses, right? You have a great idea, you reach out to your friends, you reach out to your family, they give you some money, you start a business in a garage, and four years later you have 150 employees and you're worth $100 million. How do you find that startup money in the planet that we live in right now? And I think where crowdfunding started getting some traction was, again, in the concept of job creation. Because startups are a very significant place that job creation occurs in America. And I think the kick start for all of this was job creation, ways to, you know, ways to create more wealth for people in a recessionary period. And the President gave a labor speech – I think it was probably like three and a half, four months ago – where he said that he thought that there should be a way that startup companies could raise money more easily from a network, publicly available network. So, for example, he didn't say this, but the concept is you can post on Facebook, "I'm interested in raising $100,000; would you like to invest?" And you would be able to reach out to your personal network without violating the federal and state securities laws by doing so. And so the Republicans took the President's thoughts, and the first crowdfunding bill that came out of the House, you know, and, again, these are my comments, not the comments of SecondMarket or anyone else, was kind of craziness. It would let teeny startup companies raise, I think the initial bill was up to $5 million. It would let anyone – my mom, my dad, anyone that are non-accredited investors – could invest up to the lesser of 1% of

their net income or $10,000 a year. Those holders would not count towards the 500 shareholder threshold, that would have required a company go public. They could generally solicit all kinds of stuff and the transactions—

MR. LORNE: [interposing] And fairly easy resell.

MS. TIERNEY: Correct. And, exactly. Unrestricted securities. They were state registered, so kind of in my mind a kind of roadmap to fraud.

MR. LORNE: Right.

MS. TIERNEY: So what happened was a lot of really smart people got involved with the conversation. The bill that ultimately passed the House, I believe, ended up where a company could raise up to a million dollars, same $10,000 or 1% cap, but it would have to be through a broker-dealer. And if you wanted to raise more than a million, you had to provide financial statements. So there's a disclosure concept of broker-dealer kind of protection involved. And that bill passed the House. On the Senate side I think the bill is similar to what passed in the House and is also— has passed the committee, the Senate Finance – I always get them mixed up – Senate Banking Finance Committee, whatever that one is, and is pending full Senate approval. The President has expressed on multiple occasions that he's supportive of these capital formation bills, including in his State of the Union address two days ago. So I'm not sure what we're going to see, but I think it is a really important thing that you have to have the protections I think that Reg. D affords right now and Reg. A affords as you let retail investors into these startup companies. But you're also seeing things like Kickstarter. I don't know if anyone's familiar with Kickstarter in the room. Kickstarter is a website where you can say, "Hey, I have a great idea to start a product. Send me money, and I'll give you the product when I develop it." You don't even get a return, you're just giving money to people to help them start a really cool idea. So I think you're seeing a lot of grassroots capital raising and people trying to put some sort of protections against fraudulent activity around those. I know that the SEC's really worried about it; I've heard Meredith Cross and Tom Kim mention it on other panels that I've spoken on, you know, that they really think this needs to be something where the SEC can rulemake as opposed to just a bill that creates a statute and would not be subject to SEC

interpretation. So kind of a very different planet than the one I think that most of us would be comfortable with.

MR. LORNE: Kickstarter I find sort of bizarre. I don't know how the SEC could do anything about it. You send in your money and you don't get anything for it.

MS. TIERNEY: It's not a securities—

MR. LORNE: [interposing] The only person who gets anything out of it is Kickstarter. They take a piece of the action.

MS. TIERNEY: Correct.

MR. LORNE: And companies have raised a million dollars from asking for money.

PROFESSOR KARMEL: I think that this is really not some great new idea that is going to create jobs as we've been through this kind of idea before. In the nineties there was a provision of Regulation D, Rule 504, that wasn't so terribly different from what is being proposed in these crowdfunding bills. A company could raise up to a million dollars, it could make offers to whoever it wanted to, they didn't have to be accredited investors, there wasn't a numbers cap. There was a requirement for complying with state blue sky laws, which was the only investor protection. And there was easy resell. What happened? A lot of microcap fraud, a lot of other fraud, and the SEC changed the rule. That rule no longer exists. And this is really the same rule, only using the Internet, so that even more investors could be encouraged to spend $10,000 or 1% of their income. I mean that's a lot of money. Maybe not a lot of money to people in Congress.

MS. TIERNEY: Right.

PROFESSOR KARMEL: Or people on Wall Street. But it is a lot of money for the average American. I think it's ridiculous this is going to create jobs.

MR. LORNE: And this one's coming out of the Congress so that the SEC can't just adopt a rule to change it. I mean there isn't going to be a quick turnaround if it turns out that people are getting fleeced. Which is what a rational person would expect.

PROFESSOR KARMEL: You know, the very first case I ever worked on when I was an SEC enforcement attorney had to do with the sale of a securities in a cosmetic business that was made door-to-door by milkmen in a New Jersey community. And the sales pitch was, "It's only ten cents a share." Every in-

vestor witness I talked to said the same thing when I asked, "Why did you buy this?" "Oh, it was only ten cents a share." Of course they lost all their money. The company very quickly went into bankruptcy. Is crowdfunding any different than a milkman going around to everyone on his route and collecting ten cents a share for selling [inaudible].

MR. LORNE: Yes, it's more money.

PROFESSOR KARMEL: It's more money. It's more money. It's easier to do. But it's really the same idea.

MS. TIERNEY: Well, you know, the flipside goes back to sort of, you know, this concept that why should only accredited investors get an opportunity to invest in these companies when they're starting up. Because there's also an opportunity for an excellent return. You're not always going to get it, but maybe sometimes you will. So I think that the tension is people are watching what's happening in the private markets. They're understanding that companies are taking longer to go public. They want to get in. They want to own Twitter. They want to own Facebook before it goes public. They see the pop. And I think this is just a way that Congress is trying to listen to allow small companies to raise some capital from people who really want to get into it, are going to understand that they might lose everything –.that's the concept, right? – but are willing to take that risk.

MR. LORNE: Well, and, you know, the memories of the dot-com boom, but not the bust, remain with us. And we see the Facebooks of the world and the Zyngas of the world and the outrage in the Facebook situation was that Americans were being deprived of the opportunity, not that the SEC was protecting investors. And one—

MS. TIERNEY: [interposing] But I have to say, I mean, the SEC's—Mary Shapiro, you know, there was the correspondence between Chairman Issa of the House Government Oversight Committee and Mary Shapiro last spring. If you haven't read it, it's available online; it's absolutely fascinating. But Chairman Issa said to Mary Shapiro, "The SEC has shut down public capital markets with all the rules and regulations." Which I thought was fairly humorous considering Congress passed most of the rules and regulations that public companies think are very onerous. But it's a really interesting set of correspondence. And one of the questions that he asked was,

"And did you tell Facebook that there's a general solicitation problem that they needed to take that stock offshore?" And the correspondence back from Mary Shapiro outlined a lot of very important steps that the SEC had taken to make communications easier in the context of public offerings and the fact that they were thinking about increasing the 500 shareholder threshold. The fact that they were thinking about eliminating the general solicitation prohibition in the context of private placements. And this is why I always think this is very interesting – the wording is very precise, and in that letter she also says that the SEC did not instruct Goldman Sachs to take Facebook offshore. And I know that if I got a phone call from the SEC saying, "Hey, we've been seeing the media attention around this offering, do you think you have a general solicitation problem?" Then I'm going to assume that I've got a general solicitation problem.

MR. LORNE: You would take that as a direct order.

MS. TIERNEY: Correct. So I think that the SEC is really struggling here and with good reason. The mere fact—I think—my concept of the facts from reading these papers, and it may have happened differently, you know, behind closed doors, is that Goldman did this the right way, but there was so much interest in Facebook that the offering document leaked, the media got wind of it, everybody was up in arms that rich people got to buy Facebook, and, remember, that's what the media kept saying. "Why are only rich Americans getting to buy Facebook stock?" And they created the fervor, I believe, that led Goldman to take the stock offshore. So, you know, what is a general solicitation in the context of the planet that we live in where, you know, you tweet, and the world knows what's going on in two seconds? How can companies protect themselves from that and still do private placements? Does it matter, as I said earlier, that you know that something's for sale if you cannot legally participate in that transaction? These are all really interesting topics.

PROFESSOR SMITH: I was offered the stock.

MS. TIERNEY: Were you upset when it went offshore?

PROFESSOR SMITH: No. I didn't want to buy it in the first place.

MS. TIERNEY: Well, there you go.

PROFESSOR SMITH: And, you know, it was offered to so-called high-wealth clients of Goldman Sachs, some of whom are their former partners, and I said, "You know, this is a ridiculous valuation for this company, how did they come about it?" And there was some fumbling around, and I thought that, you know, they sort of stuck their finger up in the air to sense where the wind was, and that was going to be the valuation. So I said, "Well, I wasn't going to be interested." I then asked, "How many of my broker guys, how many of your clients are signing on to this?" He said, "You know, not very many. They all seem to feel that it's really overvalued." And so I'm sure they would have found people to buy it anyway and subsequently the buzz about the thing suggested that the price was not overvalued because it went to an even higher value. But that doesn't mean it was correct. It just means that somebody, there was enough buzz out there to buy it up. So we weren't too disappointed when it went overseas where I suppose they just didn't, they didn't bother to think about valuation at all. You know, it wasn't an issue of valuation, it was a question of can I get in on this thing at the beginning. And I don't know that markets should work that way, either. So even the rich people can misjudge it—

MS. TIERNEY: [interposing] But they do in IPO context, right? How do you get into an IPO? You're a Goldman client, they're a syndicate member, you get an allocation. Most rank and file retail investors have no chance at all of getting into an IPO.

PROFESSOR SMITH: Right.

MS. TIERNEY: So it's no different. I mean you're a privileged investor, you get into an IPO.

PROFESSOR SMITH: [interposing] Well, privileged by virtue of being—

MS. TIERNEY: [interposing] If you're not a privileged investor, you don't.

PROFESSOR SMITH: —able to sustain the SEC's notion of being able to take a loss and be able to manage it—

MS. TIERNEY: [interposing] Right. But an IPO is a public company. Everybody can read the S-1, everybody understands what the risks are. Everybody should have an opportunity to participate. And that's, I think, part of why the IPO process is dysfunctional. And I think one of the things that we're reading

about in the papers is that Facebook's thinking about doing the IPO a different way and not doing it through the traditional underwriter path where the, you know, leads get the bulk of the allocation.

PROFESSOR SMITH: It will be interesting how that works out. Didn't work out very well for Google.

MS. TIERNEY: Exactly.

PROFESSOR SMITH: So maybe it will work out better this time.

MS. TIERNEY: Right.

PROFESSOR SMITH: I'm guessing it won't.

PROFESSOR KARMEL: I don't think that letter from Chairman Issa had all correct facts in it. Many of the incorrections were pointed out by Mary Shapiro in her reply. It's a highly partisan document. And it is interesting that a number of these problems have come out with extremely high profile, high tech companies like Google and Facebook. For every one of those, there are a tremendous number of business failures. And do you suppose that the, let me say, middle-class investor puts in $10,000 in some new venture, what are the probabilities that that is going to be another Facebook? Very, very, very, very low.

MS. TIERNEY: It's buying a lottery ticket, right?

PROFESSOR KARMEL: Yes.

MS. TIERNEY: But it's their money. And if they want to buy the lottery ticket, how do you protect them against making that bad decision or whether it's a good—I mean it's—you watch the SEC, you watch Congress, you cannot take risk out of the capital markets. They are never going to be a risk-free environment. But the more regulation that we put into the market in order to create less risk, the less competitive our markets are becoming. And I think that, you know, it keeps going around in the same circle.

MR. LORNE: Well, we've got about ten minutes or so until lunch and I do want to open it up for general questions. But while people are thinking of the questions, let me ask one discussion point. We've picked at a lot of ways in which the changing markets have sort of suggested that the current regulatory framework just doesn't work. Who fixes it? Who do you turn to? Because some part of it all is globalization and the development, fortunately, for the world, of markets in Europe

and Asia, but it has put a real problem on a regulatory framework that is country-based, but we don't have anywhere else to turn. The banks have more successfully approached that kind of problem with causal standards, et cetera. What do we do? How do we get there?

PROFESSOR KARMEL: I can't say who should necessarily fix it, but I can tell you who shouldn't. Our partisan dysfunctional Congress.

MS. TIERNEY: Agree.

MR. LORNE: Well, that eliminates one possibility.

MS. TIERNEY: I think that the SEC does a really good job of trying to understand the best way to do this. But things shift so quickly and, you know, Reg. NMS made a lot of sense when Reg. NMS was adopted. And yet Reg. NMS has led to high-frequency trading and dark pools and all these other things that are now considered to be problems in the market, or at least systematic issues for the market. So I think that they're doing the best they can. I think that I don't know a lot of other jurisdictions that are doing it much better than the U.S. is, so I don't think IOSCO is as effective as it could be. I don't know what the answer is. I think the SEC is the best place for it to be if the SEC is given the tools it needs to do the work. And I think that's not happening.

MS. LEE: At Liquidnet, you know, often dealing with regulators all over the country when we launch new markets with ASIC and Australia, the Australia Securities Investment Commission. The SFC in Hong Kong, et cetera, the Ontario Securities Commission. I think time and time again, in each of those meetings, one thing that rings clear to me is that disclosure is really what it's all about, and I think if we give enough disclosure, you know, we mentioned dark pools, if we have post trade disclosure and show people where these venues are, what trade took place after the trade so that all this information is out there publicly. In terms of private companies and what the valuation should be. If there's financial disclosure so that you have enough information to make that investment decision, then I think that's also the answer. So I think as long as the rules promote disclosures, the home country regulators really are the ones who kind of adopt these procedures. Because IOSCO can set standards globally, yet because every market is in such a different stage in terms of the level of trading and

different types of facilities, it's really impossible for one global rule to cover all of this. But I do believe the SEC, as Annemarie said, has done a good job of allowing these different types of venues and options for these investors, and I think that as long as disclosures are made, then investors can make the right decisions about how to trade and what to trade and what to buy.

MR. LORNE: Why don't we have any questions, if we have any, generally from the audience. Or if not—

PROFESSOR SMITH: [interposing] Well, sir, I have one point I'd like to make, if I could. I spent many years running the international business at Goldman Sachs, I was living in London for some time and traveled everywhere else. During my career there, we essentially were living with two different market structures. We had the United States market structure and we had the Euro market. The Euro market, as you know, isn't regulated by anybody. It doesn't belong to any country. It is essentially self-regulated. There are some efforts by home countries to regulate it in various ways, but on the whole it just moves to places where it will be safe from too much regulation. And so the question always came up, "Well, why should I spend money to use the U.S. market, which has a high regulatory cost, as compared to the Euro market, which had virtually none?" And the answer seemed to be because the U.S. market is a better market because people believe it's a safer and better regulated market. It provides for required levels of honesty and prevention of fraud to a degree that doesn't exist in the other place. And the differential in cost is worth it. And these two markets have coexisted for about 30 years now. And the volume of transactions in both stocks and bonds in the Euro market is now about the same, and has been for a decade or so, as the volume in the U.S. market. So we still have this choice. You can choose one or the other. But investors around the world invest in the U.S. market with a substantial preference over either their own markets or other markets beyond their own countries. You know, the U.S. attracts more than its share of its foreign investments in this way–because of the circumstances I was describing. They think the market is transparent, relatively speaking, and well-regulated on the whole. So we have to be a little careful before we decry what we have in the way of regulation here. It's sloppy, and it's inefficient, and it's behind the times as it's going to be because this is a very fast-changing world we live in and all sorts of en-

trepreneurial and innovative stuff comes along from time to time, and often it works to our advantage, though sometimes it doesn't. I think on the whole we have also moved into a sort of wholesale retail level of regulation in America when we allowed 144A and really 415 and other rules from the SEC to change the way the capital markets work. We have a whole section of being able to sort of sell securities without really registering them to qualified investors who represent the bulk of the institutional community I described at the beginning of my comments. So you might have 10,000 or 15,000 different investors to buy a Chinese stock issue through 144A. There's a quite active market here for all of that. You don't really have to bother with this other stuff if you don't want to. So we have created an opportunity for foreigners to use our market without, in a sense, being seen. And we've also created opportunities for Americans who don't want to go through the regulatory or the registration processes to use it too. Sometimes it works to their advantage, but on the whole we have decided that the SEC has two basic functions, it seems to me. One is to provide for investor protection, and the other is to provide for fair markets that aren't subject to fraud. You know, we have mechanisms for dealing with them, and on the whole we perform this reasonably well. No other country has— does it any better. In fact, most of them do it worse. And we have such sophisticated complexities here that we're not going to ever be as good at it as we might want to be, but we stick to the basic ideas that we require transparency and we require that transactions be fraud-free. And we have penalties, and we have enforcement, and we do all sorts of things to catch it. I wonder why there's some of the insider trading enforcement activities we've seen recently involving some rather high visibility people, including a director of Goldman Sachs, would have happened if that were in Germany or in London even or in other places.

MR. LORNE: Although we had a big London—

PROFESSOR SMITH: [interposing] We had a London event this past week.

MR. LORNE: Yes.

PROFESSOR SMITH: That was a weird case, I thought, but, okay, maybe so. Maybe they would have picked up on this other stuff.

MR. LORNE: They're improving the enforcement of that.

PROFESSOR SMITH: They are certainly improving. But they aren't at the same level, I think—

MR. LORNE: [interposing] No, I agree.

PROFESSOR SMITH: —as we are here. And certainly outside of the U.S. and London, outside of the Anglo-Saxon regulatory zeal countries, you know, we have very, very thin soup. And, you know, insider trading could be rampant in Japan or in India or in China or Belgium for all we know. So maybe we shouldn't worry too much about it. The broader issue of corporate governance, I think, is still a mystery to us all. How are we going to ask for corporations to behave better than we think they do sometimes, except that on the whole they behave too as well or better as companies in other countries because on the whole we hold our directors to higher standards than they are held to in other countries. And we use the courts—Roberta's right, that prosecutors and litigators and, what do you call them, plaintiffs of the bar are pretty good at making the errors be painful. So therefore they try to avoid the errors.

MR. LORNE: Thank you, Roy. And please join me in thanking the panel.