MEMORANDUM

To: Republican Members, Committee on Financial Services

From: Republican Financial Services Staff

Date: April 19, 2023

Re: Subcommittee on Capital Markets Hearing entitled "A Roadmap for Growth: Reforms to Encourage Capital Formation and Investment Opportunities for All Americans"

On Wednesday, April 19, 2023, at 2pm (ET), the Subcommittee on Capital Markets will hold a hearing, entitled: "A Roadmap for Growth: Reforms to Encourage Capital Formation and Investment Opportunities for All Americans." Testifying at the hearing will be:

- Joel H. Trotter, Partner, Latham & Watkins LLP
- Rodney Sampson, Executive Chairman & CEO, Opportunity Hub
- Henry Ward, Co-Founder & CEO, Carta
- Brandon Brooks, Founding Partner, Overlooked Ventures
- Melanie Senter Lubin, Maryland Securities Commissioner, on behalf of NASAA

The JOBS Act Created New Opportunities to Access Capital Through the Public and Private Markets

Companies have two ways of accessing capital in the securities markets to fund their operations: an initial public offering (IPO) where they sell securities publicly through a registered offering with the SEC; or a private offering under an exemption from registration. Accessing capital through an IPO is a significant step for a company because there are considerable upfront costs as well as increased costs associated with the company's ongoing reporting requirements as a public company. Before an IPO, companies incur significant costs to gather and compile mandatory information to submit to the SEC and make available to the public for the sale of its securities.[1] After an IPO, companies must continue to comply with SEC regulatory requirements, such as audit and disclosure requirements intended to provide shareholders and potential investors information necessary to make informed investment and voting decisions. However, many companies are not ready to pursue an IPO or want to avoid the costs associated with being publicly traded, particularly smaller companies. Therefore, the Jumpstart Our Business Startups Act of 2012 (the "JOBS Act") reduced regulatory barriers and

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[1] *See* Thaya Brook Knight, *A Walk Through the JOBS Act of 2012: Deregulation in the Wake of Financial Crisis*, Cato Institute (May 3, 2016), at 9, *available at* https://www.cato.org/policy-analysis/walk-through-jobs-act-2012-deregulation-wake-financial-crisis.

created new opportunities for emerging companies to access capital through our public markets and for small businesses and entrepreneurs to raise funds in private markets.

Importance of Entering the Public Markets

In a challenging global economy, the strength of our capital markets is vital to long-term economic growth. However, rising costs and increased regulatory burdens prevent small businesses from entering our public markets, depriving everyday investors of opportunities to invest in high growth companies and hindering the United States' ability to compete globally.

The number of new businesses entering public markets through an initial registration of publicly traded securities (or IPO) with the Securities and Exchange Commission (SEC) has declined, except for a surge in 2021 driven by an increase in the number of IPOs by special purpose acquisition companies (SPACs). The U.S. has recorded several of its worst years on record for IPOs,[2] while costs businesses incur to go public have doubled since the 1990s.[3] According to some reports, "Investment bankers, lawyers, and auditors collectively charge millions of dollars to prepare the lengthy registration statement that must be filed with the SEC before shares can be sold."[4]

While IPOs in U.S. markets approach their lowest point on record, the number of annual IPOs in Mainland China continues to increase.[5] In 2022, Mainland China accounted for 39 percent of all global IPO activity.[6] The launch of the Beijing Stock Exchange in 2021 and tighter regulatory restrictions on Chinese issuers on U.S. exchanges have contributed to this growth.[7] Additionally, Beijing's "Made in China 2025" agenda lays out its plan to dominate the high-tech, biotech, and artificial intelligence industries within the next ten years.[8] This increased pressure from foreign markets, especially Mainland China, only heightens the necessity for immediate action and reform.

Notably, the JOBS Act included several provisions specifically designed to strengthen public markets. For example, to encourage more small-cap IPOs, Title I created a new

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[2] *See, e.g.*, Corrie Driebusch, *IPO Market Faces Worst Year in Two Decades. 'Really Hard Pill to Swallow.'*, The Wall Street Journal (Aug. 22, 2022), available at https://www.wsj.com/articles/ipo-market-faces-worst-year-in-two-decades-startups-11661181427?mod=markets_lead_pos5.

[3] Tom Simpson, *Changes brewing in DC could make it easier for companies to go public and beef up the economy*, INLANDER (Aug. 2, 2018), *available at* https://www.inlander.com/spokane/changes-brewing-in-washington-dc-could-make-it-easier-for-new-companies-to-go-public-and-beef-up-the-economy/Content?oid=11195585; *see* Jay R. Ritter, *Initial Public Offerings: Updated Statistics* (Feb. 1, 2021), *available at* https://site.warrington.ufl.edu/ritter/files/IPO-Statistics.pdf?elqTrackId=aad710c20b5b472fbb1ae8383f6a301b&elq=929af67dfea74fdca3eed3e0b70b886c&elqaid=10789&elqat=1&elqCampaignId=6718.

[4] Frank Partnoy, *The Death of the IPO*, The Atlantic (Nov. 2018), *available at* https://www.theatlantic.com/magazine/archive/2018/11/private-inequity/570808/

[5] Ernst and Young Report: Global IPO Trends 2021 (Dec. 16, 2021), *available at* https://www.ey.com/en_gl/ipo/trends.

[6] PWC Report, Global IPO Watch: 2022 in Review, *available at* https://www.pwc.com/gx/en/services/audit-assurance/ipo-centre/global-ipo-watch.html#:~:text=The%20US%20accounted%20for%20just,number%20of%20IPOs%20since%202016.

[7] *Id*.

[8] Council on Foreign Relations: https://www.cfr.org/backgrounder/made-china-2025-threat-global-trade.

"Emerging Growth Company" (EGC) designation and an IPO "on ramp" for companies to gradually begin complying with public company regulatory requirements. Additionally, Title V raises the thresholds for mandatory registration as a public company to prevent private companies from being forced to go public before they are ready. Congress should build on the success of these provisions by introducing smart, incremental reforms that encourage companies to go public. With more companies entering our public markets, everyday investors will have greater access to investment opportunities.

The JOBS Act's Efforts to Empower Small Businesses and Entrepreneurs

The JOBS Act also included several provisions to empower small businesses and entrepreneurs. For example, Title II eased the process by which startups market their securities by extending the Rule 506 offering exemption to securities marketed through a general solicitation or advertising if the purchaser is an accredited investor. Title III allowed startups to raise funds through a new equity crowdfunding exemption. Title IV required the SEC to add a class of securities that would be exempt from registration for offerings up to $50 million.

Under the bipartisan JOBS Act, small businesses and entrepreneurs can raise capital more easily than ever before. The JOBS Act's updates to offering exemptions and the new crowdfunding exemption have opened more pathways for companies and entrepreneurs to raise capital, and companies are taking advantage of these enhancements. For example, from July 1, 2021 to June 30, 2022, issuers relying on exemptions in Rule 506 raised more than $2.3 trillion, compared to the $126 billion raised in IPOs in the same period.[9] In addition, the number and size of Regulation Crowdfunding offerings continues to increase, creating new jobs and benefiting communities outside traditional capital raising hubs.[10] In fact, as of June 2022, 160,000 workers were employed by businesses that raised funds under Regulation Crowdfunding.[11] These statistics underscore the importance of the private markets as a source of capital for millions American small businesses that are not publicly traded companies.

However, increased regulatory and other barriers continue to impede small business growth, which hinders the United States' competitiveness at home and abroad. These burdens negatively impact smaller businesses, which make up 99 percent of all enterprises in the U.S. and employ almost half of our workforce.[12] Prior to the COVID-19 pandemic, small businesses were more successful at obtaining loans, lines of credits, and cash advances with 81% of small-business applicants being approved for at least some of the funds for which they applied.[13] However, after March 1, 2020, only 70 percent of small businesses received partial approval for

[9] *See* Office of the Advocate for Small Business Capital Formation Annual Report for Fiscal Year 2022 (Dec. 2022), *available at* https://www.sec.gov/files/2022-oasb-annual-report.pdf.
[10] *Id*.
[11] *Id*.
[12] *See* Frequently Asked Questions, SBA Office of Advocacy, *available at* https://cdn.advocacy.sba.gov/wp-content/uploads/2020/11/05122043/Small-Business-FAQ-2020.pdf.
[13] Federal Reserve System, Small Business Credit Survey: 2021 Report on Employer Firms (Feb. 3, 2021), *available at* https://www.fedsmallbusiness.org/medialibrary/FedSmallBusiness/files/2021/2021-sbcs-employer-firms-report.

funds.[14] In 2021, approval rates dropped further to 68 percent.[15] The percentage of small businesses that experienced financial hardships increased from 66 percent to 80 percent between 2019 and 2020.[16]

Committee Republicans believe that entrepreneurs and founders should raise money with as little friction as possible. As a result, Congress and regulators must adopt common sense, forward-thinking policies that reduce barriers and increase access to capital raising opportunities for American entrepreneurs. By providing companies and entrepreneurs options to raise capital, we will increase American competitiveness, economic growth, and job creation.

Expanding Opportunities for Underrepresented Investors and Entrepreneurs

As discussed above, many companies want to avoid the costs associated with being publicly traded, particularly smaller companies. However, raising capital privately can be challenging for these companies as the pool of potential investors is largely determined and restricted by the accredited investor definition. This definition uses criteria such as wealth and other limited, qualitative professional criteria to determine sophistication. This limits access to private offerings and makes it harder for companies to secure funding.[17] Underrepresented entrepreneurs are particularly impacted because their potential investor pool is often limited to others within their personal network or community who do not qualify as accredited investors due to historical wealth disparities.[18]

The gap in capital raised in private versus public markets is significant, with private offerings raising $4.45 trillion from July 1, 2021 to June 30, 2022, compared to $126 billion raised in IPOs during the same period.[19] This gap highlights the investment opportunities primarily accessible to wealthy accredited investors. To increase investment opportunities for everyday Americans and help entrepreneurs raise more funds, Congress should consider policy changes that broaden the pool of investors in our private markets.

Legislative Proposals

- **H.R. 1548, the Improving Access to Small Business Information Act**, to amend the Securities Exchange Act of 1934 to specify that actions of the Advocate for Small Business Capital Formation are not a collection of information under the Paperwork Reduction Act

- **H.R. ____**, to exempt Rule 144A fixed income securities from compliance with Rule 15c2-11.

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[14] *Id.*
[15] Federal Reserve System, Small Business Credit Survey: 2022 Report on Employer Firms (Feb. 22, 2022), *available at* https://www.fedsmallbusiness.org/survey/2022/report-on-employer-firms.
[16] *See* Federal Reserve System, *supra* note 13.
[17] *See e.g.*, "What is the Role of Accredited Investors?" *available at* https://www.sec.gov/education/capitalraising/building-blocks/accredited-investor.
[18] *See* Office of the Advocate for Small Business Capital Formation Annual Report for Fiscal Year 2022 (Dec. 2022), *available at* *FY22 OASB Annual Report (sec.gov)*
[19] *Id.*

- **H.R. ____**, to amend the Securities Exchange Act of 1934 to allow 403(b) plans to invest in unregistered insurance contracts and collective investment trusts (CITs) that currently may be invested in by comparable retirement plans, such as 401ks.

- **H.R. ____, the Middle Market IPO Underwriting Cost Act**, to require the Securities and Exchange Commission to carry out a study of the direct and indirect underwriting fees, including gross spreads, for mid-sized initial public offerings.

- **H.R. ____, the Senior Security Act of 2023**, to create an interdivisional taskforce at the Securities and Exchange Commission for senior investors.

- **H.R. ____, the Enhancing Multi-Class Share Disclosures Act**, to amend the Securities Exchange Act of 1934 to require issuers with a multi-class stock structure to make certain disclosures in any proxy or consent solicitation material.

- **H.R. 2534 (116th Congress, Engrossed in House), the Insider Trading Prohibition Act**, to amend the Securities Exchange Act of 1934 to prohibit certain securities trading and related communications by those who possess material, nonpublic information.

- **H.R. __,** to carve out retirement funds and income from wealth threshold for the purposes of Accredited Investor.

- **H.R. __,** to establish fair valuations policies at private funds.

- **H.R. __,** to make crowdfunding platforms work for small business.

- **H.R. __,** to require the creation of a test, administered at the SEC, that would qualify any investor as an accredited investor.

- **H.R. ___, the Promoting Opportunities for Non-Traditional Capital Formation Act,** to require the SEC's Office of the Advocate for Small Business Capital Formation to (1) provide educational resources and host events to promote capital-raising options for underrepresented small businesses and businesses in rural areas, and (2) meet annually with representatives of state securities commissions.