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Before the U.S. House Committee on Financial Services

Subcommittee on Capital Markets

Hearing on "U.S. Public Markets Built for the 21st Century: Exploring Reforms to Make Our Public Markets Attractive for Small and Emerging Companies Raising Capital"

March 9, 2023

Chairman Wagner, Ranking Member Sherman and Members of the Subcommittee, thank you for inviting me to appear before you today. I appreciate the opportunity to appear before you to discuss how our securities laws may be improved in order to promote capital formation and foster economic growth and job creation.

I will share a little background with you to provide context for my observations today. I have been a securities lawyer for thirty years now and am a partner at Mayer Brown in New York.[1]

I was fortunate to have started practicing in the early 1990s, at a time when initial public offerings (IPOs), including IPOs by smaller companies, were plentiful, giving me the opportunity to work on many IPOs for companies of all sizes. It was also a time when the financing trajectory for companies was well understood. A successful or well-regarded emerging private company generally sought venture capital financing after having received initial funding from friends, family and angel investors. Within five to seven years of its inception, a growth company sought a liquidity event and that liquidity event was more often than not a traditional IPO. An IPO allowed a company to raise a significant amount of capital—more capital than it could then raise through any other means. Further, an IPO and listing a class of equity securities on a U.S. securities exchange was regarded as an achievement for founders and for the company's venture and institutional investors. During this time, there was a strong infrastructure that supported smaller public companies. There were equity research analysts whose role resembled that of "gatekeepers," without whose support IPOs could not take place, and who provided post-IPO coverage on the securities of these companies, and there were market makers that provided liquidity in these securities. There also were institutional investors that invested in the securities of small and midcap companies.

Over time, however, the market has evolved. Exempt offerings and hybrid offerings have become more and more significant with the increased use of shelf registration statements, the promulgation by the SEC of various safe harbors, and the shortening of the Rule 144 holding

[1] My comments today and the views I express are my own, and not those of Mayer Brown, nor attributable to any client or to any association of which I am a member.

period.[2] I played a role in this evolution by introducing hybrid securities offering formats like the PIPE transaction, the registered direct offering, the at-the-market offering, and, eventually, during the financial crisis, the confidentially marketed public offering—all of which have, in certain important respects, blurred the lines between private (or exempt) offerings and public offerings.

At the same time, the private markets have become much larger due to the growth of hedge funds, private credit funds, private equity funds, sovereign wealth funds, and family offices.[3] Venture capital investors are no longer the only available or the best available source of capital for private companies seeking to fund their growth.

The reasons for the shift away from IPOs and from the public markets occurred due to the confluence of these market structure changes and increased regulation, including the Sarbanes-Oxley Act and the Dodd-Frank Act, which increased the costs associated with being a public company.

As a result, there are fewer U.S. public companies now than there were in the 1990s. Based on statistics from the SEC's Office of the Advocate for Small Business Capital Formation, there were 4,071 U.S. public companies in 2021 compared to 7,414 in 1997. Companies also are waiting longer to undertake IPOs. The median age of companies when they have undertaken IPOs in recent years is twelve years,[4] the median market capitalization for IPO issuers has been approximately $561 million, and the average market capitalization has been approximately $1.9 billion.[5] The companies that are choosing to go public are waiting much longer to do so, are much larger when they approach the public markets, and, based on my own experience, generally, are not seeking to go public because they need to raise capital. They have many other different motivations for doing so, including providing liquidity for their shareholders.

As the public markets have declined, the private markets have grown. For several years now, reliance on funding in the private or otherwise exempt markets has outpaced reliance on SEC-registered offerings. Based on data from the SEC's Division of Economic Risk and Analysis, from July 1, 2021 to June 30, 2022, companies raised $1.1 trillion in SEC-registered offerings (and $126 billion in IPOs), and $2.3 trillion in Rule 506(b) private placements and $2.0 trillion in other exempt offerings.

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[2] I have written about many of these changes in my books, including, among others, *Corporate Finance and the Securities Laws*, published by Wolters Kluwer (sixth ed., updated 2022); and *Exempt and Hybrid Securities Offerings*, published by Practising Law Institute (2009, second ed. 2011, updated 2014, third ed. 2017, fourth ed. 2022).

[3] Assets in global private markets totaled $10 trillion in September 2021, nearly five times as much as in 2007, according to Preqin, a financial data provider. See, for example, "The Boom in Private Markets Has Transformed Finance. Here's How," Bloomberg, June 14, 2022, Dawn Lim and David Brooke. See as well McKinsey Global Private Markets Review 2022 ("Total assets under management across private markets reached an all-time high of $9.8 trillion as of June 30, 2021, up from $7.4 trillion 12 months prior."), available at https://www.mckinsey.com/~/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/mckinseys%20private%20markets%20annual%20review/2022/mckinseys-private-markets-annual-review-private-markets-rally-to-new-heights-vf.pdf.

[4] Initial Public Offerings: Median Age of IPOs Through 2022, Jay Ritter (Jan 5, 2023), available at https://site.warrington.ufl.edu/ritter/files/IPOs-Age.pdf.

[5] Statistics from IPOVitalSigns.

There has been much commentary of late regarding the growth of the private markets and concerns expressed regarding the opaqueness of the private markets. Also concerns expressed about unicorns (private companies having a valuation of $1 billion or more) and their now ubiquity. While I will focus my testimony today on the proposed bills, which relate to promoting capital formation in the public markets, it would be a grave mistake to look at the private markets as inherently suspect and in need of regulation and at the public markets by contrast as more transparent and as the best or the better solution for most or for all companies. This is a false dichotomy. Put simply, regulating the private markets out of existence would not cause institutional investors to expand their support for microcap and small cap stocks. Nor would equity research coverage spring into existence for small cap and midcap companies that would be forced to become SEC-reporting companies before they are ready to do so.

The better approach is to make it easier and more attractive for smaller and midcap companies to become public companies. The bills under consideration by the Subcommittee reflect this approach and would make helpful improvements to public company regulation. I would also note that the SEC's Office of the Advocate for Small Business Capital Formation's 2022 Annual Report also provides useful recommendations for revitalizing U.S. public markets for smaller and midcap companies as well as contains important data regarding smaller reporting companies and the challenges that they face given current regulatory requirements and market dynamics.[6]

Legislative Proposals

The bills under consideration by the subcommittee would, as I review in more detail below, extend a number of the benefits and reforms enacted by the JOBS Act, particularly by expanding the time period that a company can be classified as an emerging growth company ("EGC").[7]

Since the passage of the JOBS Act in 2012, over ten years ago, significant market practice has developed with respect to the various disclosure-based accommodations available to EGCs, which should allay any investor protection concerns. Over time, and building on the success of the JOBS Act provisions, the SEC Staff in 2017 extended to all issuers the ability to submit confidentially draft registration statements under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, for initial public offerings and for most securities offerings made within the first twelve months of the issuer having first become an SEC-reporting company.[8] The proposed bills would codify this now six-year old practice, as well as address the time periods when an EGC or any other issuer that has confidentially submitted a registration statement for SEC review must publicly file its registration statement with the SEC. Codifying these requirements and shortening these time periods will be helpful to market participants.

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[6] Annual Report Office of the Advocate for Small Business Capital Formation Fiscal Year 2022, https://www.sec.gov/files/2022-oasb-annual-report.pdf.

[7] The H.R. numbers noted in the headings of this section reflect the H.R. numbers of the 117th Congress. The discussion drafts posted at this March 9, 2023 hearing are substantially similar in content to the H.R. bills referenced in this testimony.

[8] Draft Registration Statement Processing Procedures Expanded, https://www.sec.gov/corpfin/announcement/draft-registration-statement-processing-procedures-expanded.

Importantly, the proposed bills would also expand the number of companies that could qualify for the well-known seasoned issuer, or WKSI, status. As detailed below, allowing additional seasoned issuers to qualify as WKSIs would greatly facilitate the ability of many companies to access public markets, especially due to the enhanced flexibility for communications and the ability to file an immediately effective shelf registration statement (an option that is presently available to only a small percentage of public companies). Given that the public markets are more volatile than ever, and in light of the concerns expressed regarding increased reliance on the private markets, it is reasonable to provide experienced SEC-reporting companies that are not delinquent in their public filings and otherwise meet applicable conditions, including a lower public float test, the ability to file an automatically effective shelf registration statement and seize opportunities to finance when there are "open market windows" to do so. The SEC now has in place a policy of reviewing the filings of registrants every three years so a registrant's filings would remain subject to SEC Staff review on a regular schedule, which would not be altered by the proposed change.

Below, I set forth a more detailed discussion of the various proposed capital formation bills.

Bills extending provisions of the JOBS Act

H.R. 3448-Helping Startups Continue to Grow Act; H.R. 9412; H.R. 9413; and H.R. 9411

H.R. 3448 would provide certain of the benefits and reforms available to EGCs for an additional five years provided that such companies continue to meet the other EGC requirements. Once companies cease to qualify as EGCs, they typically face significant additional disclosure and other reporting requirements, which impose substantial costs.[9] Most important from a cost and timing perspective, following loss of EGC status, the company must include with its first annual report on Form 10-K filed thereafter, an auditor's opinion on the effectiveness of internal control over financial reporting.

H.R. 3448 is consistent with the goal of the JOBS Act's IPO On-Ramp to "right-size" public company regulation To the extent an issuer continues to qualify as an EGC based on the other prongs of the definition (i.e., revenue, debt issued, and not a large accelerated filer), other than the passage of time, it ought to continue to be able to conserve its resources, continue to provide investors the same kind and quality of information it has been providing since its IPO, and not cease being an EGC and become subject to a much more onerous reporting regime merely because an arbitrary period of time has elapsed.

H.R. 9412 would codify and modify the date on which an issuer that has confidentially submitted an IPO registration statement must publicly file the registration statement with the SEC and the date on which an issuer that has confidentially submitted a registration statement relating to a follow-on offering must publicly file the registration statement with the SEC. As I noted above, in 2017 the SEC Staff extended to issuers that are not EGCs the ability to confidentially submit registration statements for IPOs and certain follow-on offerings. H.R. 9412 would codify the policy. In addition, it would reduce the time period, in the case of IPOs, from the current 15

[9] These disclosures include enhanced executive compensation disclosures and pay versus performance disclosures. In addition, an issuer will have to hold a say-on-pay vote and a say-on-golden-parachute vote (if shareholders are approving an acquisition, merger or related transaction).

days prior to commencing a road show as such term is defined in Securities Act Rule 433(h)(4) to 10 days prior to the effective date of an IPO registration statement. Given the increased reliance on test-the-waters meetings and the shortening of the period during which road shows take place, this is a sensible change that provides issuers with more flexibility and certainty.

H.R. 9413 would update the EGC financial statement requirements in order to clarify that an EGC may present two (rather than three) years of audited financial statements in connection with spin-off transactions. This would be consistent with SEC Staff views but has not been codified and should be in order to provide certainty to practitioners and market participants.

H.R. 9411 would establish that an EGC or any issuer that relied on EGC accommodations when it went public (and has ceased to be an EGC) would not be required to present financial statements or acquired company financial statements (for example, for purposes of Rule 3-05 of Regulation S-X relating to acquired businesses or Article 11 of Regulation S-X relating to pro forma financial statements). This is another important clarification that would provide much-needed certainty to practitioners and market participants.

Bill codifying current test-the-waters provision

H.R. 294, the Encouraging Public Offerings Act, would effectively codify Securities Act Rule 163B and extend the ability to test the waters that is available to EGCs to other issuers. In 2018, the SEC adopted Rule 163B, which permits issuers to test the waters prior to a registered public offering by engaging in oral or written communications with potential investors that are or that are reasonably believed to be qualified institutional buyers or institutional accredited investors without such communications being considered "gun jumping" communications.[10] Given that the broader access to the test-the-waters provisions have existed since 2019, and have not raised any investor protection concerns, it is both reasonable and appropriate to codify this communication safe harbor.

It is also well worth noting that the SEC has not taken up any broader review of the offering related communications rules or safe harbors since 2005, when Securities Offering Reform was adopted. In the 18 years since Securities Offering Reform, there have been significant advancements in communications—yet, we still operate with anachronisms like a post-IPO "quiet period." Also worth noting is that the last interpretative guidance on social media and the securities laws was issued by the SEC in 2000. Consideration should be given to directing the SEC to undertake a study regarding the communications rules and related safe harbors since these are closely tied to the ability to raise capital, provide investors with timely information, and align information that may be available in the public domain with information in a registrant's public filings.

Low Revenue Issuers

Another bill under consideration would exempt certain low-revenue issuers from Section 404(b) of the Sarbanes-Oxley Act, which require public companies to have their management's

[10] Solicitations of Interest Prior to a Registered Public Offering, Release No. 33-10699 (Sept. 26, 2019), https://www.sec.gov/rules/final/2019/33-10699.pdf.

assessment of the effectiveness of internal control over financial reporting attested to, and reported on, by an independent auditor.

The SEC's Office of the Advocate for Small Business Capital Formation's 2022 Annual Report's statistics relating to small exchange-listed companies (issuers with a market capitalization of $250 million or less) is even starker than the numbers relating to U.S. public companies as a whole discussed above. For example, in 1982, there were 4,144 U.S. small exchange-listed companies. The number declined to 3,140 by 2002, then to 1,415 in 2012 when the JOBS Act was enacted, and in June 2022 was 1,587. The aggregate market capitalization of these small exchange-listed companies as a proportion of the overall market has declined from 13% in 1982 to 0.4% in 2022—that is a remarkable decline. The Report documents many of the issues encountered by smaller public companies—from lack of equity research coverage to lack of liquidity in the market for their securities (which is related to the lack of research coverage) to inability to raise capital in follow-on public offerings to high compliance costs. The Report documents the average internal annual Sarbanes-Oxley Act compliance costs—many of these costs are disproportionately higher for smaller reporting companies.[11] Academic studies have shown that there is little evidence as to whether an internal control over financial reporting (ICFR) audit affects ICFR quality or the informativeness of management internal control reports and the ultimate quality of financial reporting.[12] Yet, the costs associated with the Section 404(b) attestation requirement are significant, and, as indicated in various studies, have not declined over time and are not scaled proportionately for smaller companies so these companies may bear a disproportionately negative impact from the requirement without there being a commensurate proven benefit from a disclosure or investor protection perspective.

When the SEC amended the definition of "smaller reporting company," it provided some relief for certain low-revenue companies from Section 404(b) attestation requirements—there has been no evidence that this change resulted in any investor protection concerns. As a result of the amendments to the definition, smaller reporting companies with less than $100 million in revenues are exempt from the auditor attestation requirements under Section 404(b) and accelerated reporting deadlines. Of course, an issuer that qualifies as a smaller reporting company due to a public float between $75 million and $250 million, and has annual revenues in excess of $100 million, continues to be both a smaller reporting company and an accelerated filer, and therefore remains subject to the auditor attestation requirements under Section 404(b), which should be addressed. To the extent that this bill addresses EGCs that lose their exemption from the Sarbanes-Oxley Section 404(b) attestation requirement solely as a result of the passage of time but remain low-revenue issuers, it would be reasonable to provide relief so that these companies can conserve their resources to further their research and development and advance their growth.

Exchange Act Section 12(g) Threshold

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[11] Annual Report Office of the Advocate for Small Business Capital Formation Fiscal Year 2022, https://www.sec.gov/files/2022-oasb-annual-report.pdf.

[12] See, for example, McCallen, Jennifer and Schmardebeck, Roy and Shipman, Jonathan E. and Whited, Robert Lowell, Evidence on the 2020 Exemption of Low-Revenue Issuers from the Internal Control Audit Requirement (May 30, 2022). Available at SSRN: https://ssrn.com/abstract=3420787 or http://dx.doi.org/10.2139/ssrn.3420787.

H.R. 9459 would modify the Securities Exchange Act Section 12(g) threshold, which triggers public reporting, in order to provide that the 2,000 or more holders of record shall exclude Qualified Institutional Buyers (QIBs) and institutional accredited investors. Under Section 12(g) of the Exchange Act, as amended by the JOBS Act, the Exchange Act reporting requirements are not triggered if the issuer has fewer than 2,000 holders of record of its equity securities and fewer than 500 holders of record who are not accredited investors.

As noted earlier, unfortunately, discussions regarding whether the Section 12(g) threshold should be recalibrated in order to prevent companies from staying private "too long" lack a basis in fact. The JOBS Act modified the Section 12(g) threshold; however, the JOBS Act is not responsible for changing the capital markets and the JOBS Act was not the catalyst for the growth of the private markets. The growth of the private markets and the availability of funding from a multiplicity of private capital sources has contributed to companies staying private longer. Similarly, many other factors, such as the market structure changes to which I alluded earlier, and regulatory developments, also have contributed to companies choosing to defer IPOs or preferring mergers or other strategic alternatives rather than becoming public companies. The public markets are no longer particularly welcoming to smaller public companies. Smaller company IPOs generally do not fare as well as the IPOs undertaken by companies that are larger (by market capitalization at the time of their IPO). Forcing a company to become subject to SEC reporting will not change market dynamics. Accordingly, institutional investors should not be "counted" toward the 2,000 holder of record prong of the Section 12(g) threshold that would trigger SEC reporting requirements. By excluding these holders from the count, companies would effectively have greater flexibility to remain private. This change would also not affect the information that is available to these investors. QIBs and institutional accredited investors are able to fend for themselves and obtain the information that they require to make informed investment decisions regarding private placements. In connection with making their investments in private companies, institutional investors generally negotiate for themselves information rights, as well as affirmative and negative covenants that allow them to monitor to an extent the activities of the companies. These rights are, from a business perspective, what the investors believe to be adequate to protect the value of their investments. We should rely on private ordering to determine the information companies provide to institutional shareholders.

Well-Known Seasoned Issuer (WKSI) Eligibility

H.R. 9562 would extend WKSI status to all companies that otherwise satisfy the WKSI definition and that have a public float of $75 million.

Given that WKSIs are seasoned issuers and are generally well-followed companies, WKSIs are subject to the least burdensome offering and communication requirements. Perhaps most important, a WKSI may file an automatically effective shelf registration statement and post-effective amendments. A WKSI automatically effective shelf registration statement also may omit certain information and the specific offering-related details can be provided at the time of a specific transaction, providing the issuer with enhanced flexibility. The issuer also can defer the payment of registration fees until the time that it actually undertakes an offering (referred to as the "pay-as-you-go" approach). As companies are increasingly concerned about publicly announcing any follow-on offering and having such an announcement result in shorting activity in their securities or other aberrational trading, being able to time the filing of a shelf registration

statement until it is needed will be an important tool. For a company that would like to be able to raise capital in the public markets to fund an acquisition, knowing that it can file an automatically effective shelf registration statement will be meaningful. The alternatives now available in such an instance are far less appealing and much more expensive. A company that does not already have an effective shelf registration statement in place would have to file a new shelf registration statement with the SEC (or a registration statement relating to a particular proposed offering) and subject itself to the possibility of SEC Staff review. During this time, the market may react poorly to the filing of the registration statement. This waiting period, whether to learn if the registration statement will be reviewed, or for the SEC Staff comments if the filing will be reviewed, results in significant uncertainty for a company since it cannot time when it will be able to access the public markets. Of course, the company might choose to finance by conducting a private placement or other exempt offering; however, there will still be a liquidity discount associated with any such offering alternative compared to a public offering. As a result, making an automatically effective shelf registration statement more broadly available will provide greater flexibility to public companies and should lower their cost of capital.

A WKSI also has greater flexibility with respect to oral and written communications, such as greater flexibility relating to the use of free writing prospectuses, which may also be important to many issuers. As I noted above, given that the SEC Staff is now regularly reviewing the periodic filings of issuers on a three-year cycle, there should be no investor protection concerns with providing seasoned issuers that meet the other prongs of the WKSI definition (other than the current float test) with a better path to raising capital.

Research

Finally, given the importance of research in creating markets for small and medium sized companies, it is important to codify the SEC's no-action letters that have provided relief from MiFID II and allow broker-dealers to receive cash payments for research without being deemed to be subject to the Investment Advisers Act. MiFID II affects investment managers located outside of the European Union and the United Kingdom. Non-U.S. investment managers rely on research provided by U.S. broker-dealers and U.S. investors invest in funds that are managed by investment managers that are subject to MiFID II. MiFID II requires, among other things, the unbundling of research payments from trade execution payments. However, the receipt of payments for research services directly or indirectly out of an investment manager's own money subjects broker-dealers' research services to the Investment Advisers Act, which has different requirements and subjects broker-dealers to an additional and entirely different regulatory regime, as well as the broker-dealers' current regulatory regimes overseen by the SEC and the Financial Industry Regulatory Authority (FINRA). The availability of research is essential to well-functioning capital markets, but there has been a reduction in the amount of research available since the introduction of MiFID II. Codifying the SEC Staff's no-action letter relief would forestall further negative impacts while necessary additional regulatory changes are assessed and evaluated.

Concluding Thoughts

Additional reforms should be considered to address the issues facing smaller public companies, but today's proposed measures are a good step in the right direction. It is for all of these reasons,

that I support the proposed bills while, of course noting that the SEC’s administrative flexibility relating to the implementation of many of the specific measures contemplated here should not be negatively impacted.