Written Testimony of

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Subcommittee on Capital Markets

"Empowering Entrepreneurs: Removing Barriers to Capital Access for Small Businesses"

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Chairwoman Wagner, Ranking Member Sherman, and esteemed members of the subcommittee, thank you for the opportunity to appear before you today to discuss capital access for entrepreneurs and small businesses.

My name is Alexandra Thornton. I am a senior director focusing on financial regulation and tax policy at the Center for American Progress, an independent, nonpartisan policy institute that is dedicated to improving the lives of all Americans through bold, progressive ideas, as well as strong leadership and concerted action.

Entrepreneurs and small businesses have been an important part of the American success story from our country's beginning. As SEC Commissioner Caroline Crenshaw said last week, small businesses "form the backbone of communities, are drivers of jobs, are critical for the development of new ideas and new technology, and are an avenue to wealth creation…"[1]

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[1] Commissioner Caroline A. Crenshaw, "'Big 'Issues' in the Small Business Safe Harbor: Remarks at the 50th Annual Securities Regulation Institute," U.S. Securities and Exchange Commission, January 30, 2023, available at https://www.sec.gov/news/speech/crenshaw-remarks-securities-regulation-institute-013023.

Entrepreneurs and small businesses make an enormous contribution to the innovation and creativity that America is known for, and they benefit a great deal from our capital markets. They could play an even bigger role in our economy, but lack of funding from the capital markets is not what is holding them back.

The simple reality is that, if a small business wants to get a loan, it has to go to a bank and fill out detailed loan application documents with information about its assets, projected finances, operations, and more. Its executives may have to offer meaningful collateral, such as their homes or their essential equipment and inventories. Those business loans are considered by the banks and their regulators to be among the riskiest activities in banking. Thus, they are subject to significant regulatory limitations, reviews, and compliance processes. For example, federal banking regulators frequently release guidance and notices intended to inform banks' risk management in lending to small businesses.[2]

By contrast, if a company wants to turn to the capital markets to raise capital, there may be no substantive, regulatorily imposed requirements at all. Today, after decades of deregulation, a company can raise an unlimited amount of money from an unlimited number of "sophisticated" investors without making any disclosures at all. As the SEC itself explained in 2019, "[i]ssuers in [Rule 506] offerings are not required to provide any substantive disclosure and are permitted to sell securities to an unlimited number of accredited investors with no limit on the amount of money that can be raised from each investor or in total."[3]

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[2] See, e.g., Small Business Administration Lending Risk Management Principles, Office of the Comptroller of the Currency, OCC Bulletin 2021-34, available at https://www.occ.gov/news-issuances/bulletins/2021/bulletin-2021-34a.pdf.

[3] "Concept Release on Harmonization of Securities Offering Exemptions," U.S. Securities and Exchange Commission, 84 Fed. Reg. 30460, 30470, June 26, 2019, available at https://www.govinfo.gov/content/pkg/FR-2019-06-26/pdf/2019-13255.pdf.

Unlike banks and their employees, private equity and venture capital investors are generally not expected to follow regulator-mandated, standardized documentation requirements (and regulatory oversight) of their capital allocation decision making. This has become a hot issue, as the SEC is reportedly examining some venture fund investors' practices for potentially unreasonably overfunding private companies. This suggests that the capital markets may be giving private companies and funds too much money.

It is worth noting that small companies can also raise money through leveraged loans that are packaged into collateralized products—a practice that has been institutionalized in private equity and hedge funds and grown exponentially to trillions of dollars today.[4]

Venture capital and private equity funds are larger than at any time in history, and they also have more cash-like reserves on hand than at any time in history. This has created what has essentially become a sellers' market for many private issuers – and led to a deterioration in due diligence by many investors and ever rising private market valuations.

The problem is not that the rules prevent small businesses from obtaining capital; it is that the rules today allow companies with billion-dollar valuations, billions in revenues, and thousands of investors to never provide basic information to investors, regulators, or the public, and private funds to raise billions of dollars from underlying investors without basic expectations like timely, comprehensive, and reliable disclosures about their finances, governance, or operations. There is no regulatory requirement for these billion-dollar enterprises to provide investors with basic audits.

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[4] See, e.g., "A Giant in the Shadows: Subprime Corporate Debt," Americans for Financial Reform Education Fund, January 2023, available at https://ourfinancialsecurity.org/wp-content/uploads/2023/01/1.6.23-Subprime-Corporate-Debt-A-Giant-in-the-Shadows.pdf.

Congress and the SEC created this perverse regulatory regime in the name of capital formation. Yet, as we have seen with Theranos, WeWork, and so many others, the current capital markets regulatory regime enables capital distortion. The regime does so in various ways, such as inflated valuations, lax internal controls, inconsistent disclosures across investors, and potential fraud and abuse.[5]

When Congress established the federal securities laws and created the Securities and Exchange Commission to implement them, it was responding to the massive investor losses and waste of the Great Crash of 1929. Congress was concerned that, without basic information about a company's finances, governance, and operations, capital would be mis-allocated and wasted. The fundamental bargain then and now is that companies that want to raise capital from the public must first provide basic information to investors and the public, including the company's financials, governance, operations, and risks. Today, public companies even need to be audited, and their auditors are subject to significant regulatory oversight. These robust audits are essential to promoting the integrity of the companies and the markets in which they operate. This disclosure of information improves price discovery, makes the markets more fair, more orderly, and more efficient, and protects investors from abuses, such as information asymmetry. Even the most sophisticated investors cannot exercise their superior knowledge and expertise if they do not have reliable information about a company's financials, operations, and risks – a lesson that, sadly, has had to be re-learned with great frequency.

When the securities laws were first adopted, and in the decades thereafter, offerings to even a single person or to a small number of employees were deemed to be public offerings in need of being registered. Congress and the SEC have since reversed those decisions, with increasingly alarming results.

[5] Crenshaw, January 30, 2023.

Beginning in 1982 with the promulgation of Regulation D, there has been a proliferation of exemptions from the public disclosure framework.[6] The stated intention of those exemptions and their subsequent expansions has been to provide more access to capital for small businesses.[7] But the reality is that those exemptions, along with a couple of loopholes in the law, have enabled virtually any company of any size to obtain capital from the public without complying with the public disclosure framework.

As a result, a substantial and growing number of companies are choosing to remain private as they raise capital, and often only end up coming to the public markets to cash out significant investors or founders. The result of Congress and the SEC creating and expanding exemptions from the federal regulatory disclosure framework is that the vast majority of capital raised is exempt. That explosive growth of the private markets has come at the expense of public markets.[8]

If a company can raise all the capital it needs in the private markets without making disclosures, developing robust operational safeguards, subjecting itself to audits, having a headquarters, dealing with a large number of retail investors, exposing details of its sales or operations to its competitors, suppliers, customers, or other business partners, or subjecting itself to SEC oversight and potential class action plaintiffs, why would it go public?[9]

The situation is truly alarming. Today, there are more than 650 U.S. private companies worth more than a billion dollars each in the U.S. private markets.[10] The number is going up every year.[11] Commissioner

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[6] Elisabeth De Fontenay, "The Deregulation of Private Capital and the Decline of the Public Company," Hastings Law Journal, Vol. 68:445, 2017, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2951158.
[7] Crenshaw, January 30, 2023.
[8] George S. Georgiev, "The Breakdown of the Public-Private Divide in Securities Law: Causes, Consequences, and Reforms," Emory University School of Law, Fall 2021, available at https://scholarlycommons.law.emory.edu/cgi/viewcontent.cgi?article=1001&context=faculty-articles.
[9] See, e.g., "In the Public Interest," Healthy Markets Association, January 2022, available at https://healthymarkets.org/product/public-vs-private-markets-a-special-report.
[10] CB Insights, The Complete List of Unicorn Companies, available at https://www.cbinsights.com/research-unicorn-companies.
[11] Georgiev, 2021.

Crenshaw pointed out that these "unicorns," as they are called, "have consistently relied on Rule 506 of Reg D to raise billions of dollars in U.S. capital."[12] These companies are allowed to grow extremely large, competing with similar publicly traded companies and selling products and services to a broad swath of the American public, without making meaningful disclosures. As the recent examples of large, opaque company failures demonstrate,[13] these companies can pose huge risks to their investors, the economy, and the country. They do not belong in the private markets.

Rather than enabling small businesses to access needed private capital, Regulation D and other exemptions are being used by companies of all sizes to skirt the disclosure requirements Congress established to ensure transparency and investor protection. There are many steps that Congress and the SEC can take to rebalance the public and private markets and make more room for capital for small businesses.

Section 12g of the Securities and Exchange Act of 1934[14] was intended to prevent companies from becoming too large without adhering to the public disclosure framework. Originally enacted in 1964, it required expanded disclosures when a private company reached 500 holders of record, which the JOBS Act of 2012 increased to 2,000. When 12g was enacted, the number of holders of record was closer to the number of actual owners of shares. But now, due mainly to changes in technology, the holder of record definition is exponentially larger since intermediaries today may hold millions of shares *on behalf of* thousands of investors yet are counted as one holder of record for purposes of the threshold. This is why Facebook was able to remain a private company and avoid public disclosures for years after it had

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[12] Crenshaw, January 30, 2023.

[13] See, e.g., Gillian Tan, Liana Baker, and Michelle Davis, "WeWork Postpones Long-Awaited IPO, Sending Its Bonds Falling," Bloomberg, September 16, 2019, available at https://www.bloomberg.com/news/articles/2019-09-16/wework-is-said-to-likely-delay-ipo-after-valuation-plummets?srnd=premium&sref=S5RPfkRP; and Zaw Thiha Tun, "Theranos: A Fallen Unicorn," Investopedia, January 4, 2022, available at https://www.investopedia.com/articles/investing/020116/theranos-fallen-unicorn.asp.

[14] 17 CFR Section 240.12g-1.

thousands of shareholders.[15] Clarifying that "holder of record" under Section 12g means actual security owners or beneficial owners , not intermediaries, would help ensure that smaller businesses are not competing for capital in the private markets with huge companies.

A critical companion measure would be for Congress to statutorily require all very large companies and funds to be public. These companies and funds may have significant impacts on investors, but also markets overall and commerce generally. For example, there should be no such thing as a unicorn. Companies with billion-dollar valuations should be required to make basic public disclosures of their finances, governance, and operations, as should companies with more than 250 employees.

Beyond that, instead of trying to expand exemptions that are currently being used by much larger companies, Congress could do more for small businesses by scaling back the exemptions to their intended purpose, possibly eliminating some of them altogether, and by building on the success of the public markets with their mandatory disclosures. In this way, businesses would be more fairly competing for investors' capital, as well as more fairly competing against one another.

Together, these measures would go a long way toward restoring the private markets to the businesses and investors they were intended for, while ensuring that larger companies that raise capital from the public comply with the public disclosure framework and thus provide the information those investors need to make investment decisions.

Thank you again for inviting me to testify today. I look forward to answering your questions.

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[15] Steven Davidoff Solomon, "Facebook May Be Forced to Go Public Amid Market Gloom," New York Times, November 29, 2011, available at https://archive.nytimes.com/dealbook.nytimes.com/2011/11/29/facebook-may-be-forced-to-go-public-amid-market-gloom/.