REDUCING BARRIERS TO CAPITAL FORMATION, PART II

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

JULY 10, 2013

Printed for the use of the Committee on Financial Services

Serial No. 113–38

U.S. GOVERNMENT PRINTING OFFICE

82–860 PDF WASHINGTON : 2014

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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REDUCING BARRIERS TO CAPITAL FORMATION, PART II

Wednesday, July 10, 2013

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Hurt, Royce, Neugebauer, Huizenga, Grimm, Fincher, Mulvaney, Hultgren, Ross, Wagner; Maloney, Lynch, Scott, Himes, Peters, Watt, Foster, Carney, Sewell, and Kildee.

Also present: Representatives Fitzpatrick and Duffy.

Chairman GARRETT. Good morning, all, and welcome.

The Subcommittee on Capital Markets and Government Sponsored Enterprises is hereby called to order. Today's hearing is entitled, "Reducing Barriers to Capital Formation, Part II," which implies there was a Part I, and how many more we will have is anybody's guess, but this is Part II.

So, I welcome the panel. We will look forward to your testimony shortly. We will begin with opening statements, and I will yield myself about 5 minutes, and go from there.

As I said, today's hearing will focus on reducing barriers to capital formation for America's small businesses. Following the most recent financial crisis, there can be little doubt that America's big businesses are doing better than the small businesses. Under the Obama Administration, small businesses have become mired in a river of costly government red tape.

Indeed, the steady flow of overly burdensome regulations coming out of Washington, D.C., these days is disproportionately affecting small businesses, imposing enormous compliance costs, and cutting off access to the critical sources of capital these firms need to be able to grow, and grow the economy and to create more American jobs.

So it is no wonder that the National Federation of Independent Businesses' Small Businesses Optimism Index fell in June, and 67 percent of small businesses indicated in a recent survey that they do not have plans to hire in the next 6 months. That is a one-point decrease from the fourth quarter of 2012.

Despite the regulatory headwinds facing small businesses today, there are some signs that the landscape for small business capital formation is improving. For one thing, self-executing provisions of the JOBS Act are already helping small businesses gain access to the U.S. equity market.

For example, IPO activity surged in the second quarter of 2013 with emerging growth companies (EGCs) under the JOBS Act accounting for 77 percent of all IPOs as a price during this period, and a 79 percent of the EGCs IPOs during the second quarter made use of the JOBS Act confidential filing provisions.

In addition, while the SEC has historically only paid some lip service to small business capital formation, as I speak, an open meeting is currently under way at SEC headquarters to finally vote on amendments to eliminate the band on general solicitation and general advertising in certain private sector securities offerings, which was mandated by the JOBS Act more than a year ago.

I expect that the outcome of the Commission's meeting today will provide a significant new avenue for small business capital formation while protecting investors by providing those who are accredited with additional investment options.

American companies and investors also caught a much-needed break from overly burdensome SEC regulations last week when a Federal judge vacated an SEC ruling issued under the Dodd-Frank Act requiring disclosure of payments to government entities by companies engaged in resource extraction.

As I mentioned before, whatever commendable goals this rule might have had, it has absolutely nothing to do with the causes of the most recent financial crisis; it was always outside of the SEC's core area of expertise.

Given the validity of a similar SEC ruling requiring companies to disclose their use of conflict minerals, which is still before the courts, I would like to take this opportunity to urge Chairman White not to revisit any rulemaking on resource extraction.

Moreover, I urge her to instead focus on the SEC's core mission by first completing more relevant congressional mandates including Regulation A, the overcrowding provisions of the JOBS Act, and removal of references to credit rating agencies in the Federal securities laws pursuant to Section 939(a) of the Dodd-Frank Act.

With the economy growing now at an anemic 1.8 percent during the first quarter of this year, it is imperative that Congress and the regulators continue to build off the momentum created by the JOBS Act and explore new ways to provide our startups and small businesses with the capital they need to grow their operations, create jobs, and breathe more life into the U.S. economy.

At our hearing on this topic last month, and in the prepared testimonies submitted by our panel today, we have received a number of ideas to promote small business capital formation.

These ideas include, among others: modernizing the regulatory regime governing business development companies (BDCs); expanding tick sizes to increase liquidity in the shares of publicly traded small cap companies; establishing a new parallel stock market for small public companies; increasing research analyst coverage for small and mid-cap companies; appropriately scaling Federal regulations governing M&A brokers; exempting small SEC reporting companies from the SEC's XBRL filing requirements; and a variety of other measures to update our security laws and generally improve the infrastructure of our capital markets.

With all that said, I look forward to continuing to discuss these ideas and other ones which I didn't go through as we move forward in drafting legislation that will hopefully further reduce barriers to small business capital formation and create more American jobs.

I yield back.

And I yield to the gentlelady from New York for 4 minutes for her opening statement.

Mrs. MALONEY. Thank you, Mr. Chairman. I want to thank all of the witnesses for being here today. And thank you, Mr. Chairman, for really focusing on the important goal of job creation.

The United States has the deepest and most effective capital markets in the world. The U.S. stock market is 13 times larger than the British stock market, and 14 times larger than the German stock market.

The sheer size of our market is attractive for its investors because they know they will be able to sell their investment quickly if they need to. But unfortunately, small businesses still have trouble raising funds in this markets. Between 1991 and 2007, the number of small companies that went public in our securities markets declined by 92 percent. Providing incentives for greater investment in our country's small businesses and entrepreneurs will allow these companies to innovate and grow our economy and create more jobs.

That is why we passed the JOBS Act, which removed several regulatory barriers to small business investment. For example, the JOBS Act allows small businesses to use general advertisements to solicit investors, allows certain businesses to phase in SEC regulations over a 5-year period, and raises the number of shareholders that would trigger mandatory SEC registration from 500 to 1000.

Of course, we need to monitor the implementation of the JOBS Act and make sure that small companies get access to the capital they need. I look forward to hearing from the witnesses what regulatory factors make financing for small businesses more difficult and what Congress can do to help.

Small companies should not be forced to spend the majority of their limited resources complying with securities regulations. They should be spending their money hiring new workers or investing in new products.

We need to keep in mind that one of the main reasons the U.S. capital markets are the envy of the world is the transparency and trust that comes from our disclosure rules. I have always said that markets really run more on trust than they do on capital, and we have the most trusted markets in the entire world.

Less transparency in our capital markets will open the door to misrepresentation, which invariably targets the most vulnerable investors such as retirees. That is why we must ensure that we strike the proper balance between maintaining healthy financial disclosure and reducing companies' compliance costs.

I know that many of you have come forward with a variety of ideas. I have read your testimony, and I look forward to your testimony today. I do want to note that I have a conflict with the Joint Economic Committee, on which I am the ranking member. I must run over there for a period, but I will definitely be back here for questions.

I deeply appreciate your testimony and your being here today.

Thank you, and I yield back.

Chairman GARRETT. The gentlelady yields back.

I recognize Mr. Fitzpatrick for 2 minutes.

Mr. FITZPATRICK. Thank you, Mr. Chairman. I appreciate the opportunity to offer a couple of remarks at this hearing.

Today's hearing is about regulatory reform. It is about capital formation, but ultimately it is about jobs, and I have had the opportunity to work with BIO and pharmaceutical businesses that create good paying jobs in my district in Pennsylvania and they have shared with me how regulatory relief related to capital formation would positively affect their research and their ability to hire, to create jobs, and to hire folks from Pennsylvania.

For every dollar they must spend on compliance, that is money being taken away from research and development, and the problem isn't that they are necessarily opposed to regulation; it is that they are being unfairly treated as large companies despite the fact that they are small and emerging growth companies. This one-size-fits-all approach to regulation is just the type of barrier to economic growth that we need to be tearing down.

That is why I have introduced the Fostering Innovation Act of 2013, and this is a bill which is identical to legislation that was passed by this subcommittee in the 112th Congress.

The Fostering Innovation Act would help provide permanent regulatory relief for small and emerging growth companies by more accurately reflecting the difference in large and small companies.

For instance, currently, a company with market capitalization or public float of $75 million or more is subject to Section 404(b) of Sarbanes-Oxley (SOX) and that requires external audits of internal controls. This bill would raise that to a more accurate number of $250 million.

Second, my bill would apply a much needed revenue test for determining which companies must comply with regulations like 404(b). Currently, a company could have a public float exceeding $250 million but be making very little money and still be considered to be a large company by the SEC.

As Mr. Moch from BIO can attest, this is actually something fairly common in the biotech industry and in fact, would apply to the two companies I have mentioned earlier that I am working with in my district.

So I just wanted to come, and briefly highlight the Fostering Innovation Act.

I would like to thank all of the individuals here to testify today for touching on this bill perhaps and I appreciate the chairman's calling the hearing. This hearing is extremely important for, as I said, capital formation, but ultimately for job creation across our country.

Thank you again, Mr. Chairman, for the time.

Chairman GARRETT. I thank the gentleman. The gentleman yields back.

Mr. Scott is recognized for 2 minutes.

Mr. SCOTT. Thank you, Mr. Chairman, for this hearing.

This is a very important hearing as we discuss ways in which we can reduce barriers, and what is important is that we identify those barriers that we as policymakers can truly do something about.

I think it is very important that small business companies have great potential for technological motivation and job creation, that we truly examine and find out from our distinguished panel what precise things they feel we can do.

I think we have to go beyond—we have to look at what we refer to as burdensome overregulation. We need to truly examine that to see where we can make effective changes, but we also have to look at the bigger picture. What else is out there?

We know that the Securities and Exchange Commission has a three-part mission to protect investors, maintain fair order and efficient markets, but also a part of their mission is to facilitate capital formation, and they have a pilot program going. I think we ought to examine that just a bit.

Whether it is allowing for a larger size of increments of bids in what we call tick sizes for smaller companies, an option that is currently under consideration by the SEC, or some of the more controversial options, some of which I think they have discussions like increasing the size of companies exempted from Sarbanes-Oxley's auditor attestation requirements or looking at ways in which maybe smaller companies might be exempted from the shareholders advisory votes on executive pay and compensation.

These are all somewhat controversial, but they are standing in the way of us making sure that we have capital formation going out to our companies.

And then finally we have to take a look at the JOBS Act, which was signed into law a little more than a year ago, and see what more we can fully do.

With that, I yield back, and I look forward to the distinguished panel.

Chairman GARRETT. Thank you, and the gentleman yields back.

We now turn for 2 minutes to the gentleman from Virginia.

Mr. HURT. Thank you, Mr. Chairman. Thank you for holding today's hearing, the second in a series on exploring ideas for reducing barriers to capital formation.

I thank each of the witnesses for being here today.

One of the most important functions of this subcommittee is to promote initiatives to increase access to capital for our small businesses and startups. It is appropriate that the Capital Markets Subcommittee will again lead the way on initiatives to increase capital access and promote economic growth after a champion enactment of the JOBS Act in the last Congress.

While the JOBS Act was an important step forward, these hearings show that more still needs to be done to ensure that we remove costly and unnecessary regulatory impediments that are restricting companies from accessing capital in the public and private markets.

I especially look forward to testimony from our witnesses about the extensible business reporting language (XBRL), which was mandated by the SEC in 2009.

Despite the SEC's intent of lowering the cost of capital for smaller companies and providing more efficient access to information for investors, this requirement has become another example of a regulation where the costs far outweigh any potential benefits.

Companies expend tens of thousands of dollars or more complying with the regulation, yet there is evidence that less than 10 percent of investors actually use XBRL, further diminishing its potential benefits.

This is another example of an unnecessary and costly requirement that disincentivizes innovative companies from accessing the public markets. We must look at solutions to this issue and others to create a regulatory environment that is more efficient and conducive for long-term economic growth.

I appreciate this committee's continued focus on ensuring that our small businesses and startups have the ability to access the necessary capital in order to innovate, expand, and create the jobs that our communities need.

I look forward to the testimony of our witnesses, and I thank you again for your appearance before the subcommittee today.

Thank you, Mr. Chairman. I yield back the balance of my time.

Chairman GARRETT. The gentleman yields back.

Seeing no other opening statements, we will now turn to the panel.

And again, welcome to the entire panel. Your entire written statements will be made a part of the record, and you will be recognized now for 5 minutes. In front of you, of course, is the timer: green when you start; yellow as a 1-minute warning light; and red for when you should be done.

And the other admonition I always ask you is to make sure that your microphone is turned on, and the microphone is pulled closer than it is for some of you right now when you do actually speak.

So with those introductory comments, I recognize Mr. Leach for 5 minutes, and welcome.

STATEMENT OF RAYMOND T. LEACH, FOUNDING CHIEF EXECUTIVE OFFICER, JUMPSTART, INC., ON BEHALF OF THE NATIONAL VENTURE CAPITAL ASSOCIATION (NVCA)

Mr. LEACH. Good morning, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. Thank you for the opportunity to share with you today the venture capital perspective on the state of the capital market system.

Venture-backed companies that go public are drivers of the U.S. economy. That is why the NVCA supported the passage of the JOBS Act in 2012, in particular, the IPO on-ramp provision.

I want to thank you for your work on making the JOBS Act possible and for continuing to direct your attention to market concerns that affect companies once they have gone through an IPO.

A successful IPO drives extremely positive economic outcomes. First, it allows companies to raise additional capital to invest in growing their business, to increase its revenues, and to create new jobs. Data shows that 92 percent of job growth from venture-backed companies occurs after going public.

Second, IPOs enable all types of investors to participate directly in the company's growth and provide financial benefits to employees who have also earned equity in the company pre-IPO.

Third, IPOs typically generate meaningful returns for pension funds, endowments, foundations, and other limited partners who pooled their money with VCs to invest in these firms.

Lastly, companies that go public have the potential to transform regional economies and communities in significant ways.

The decline of the U.S. IPO market over the last 15 years has been well-documented. From 1990 to 1996, 1,272 U.S. venture-backed companies went public in the United States on U.S. exchanges, yet from 2004 to 2010, only 324 companies did so.

Most analyses have pointed to a complex series of changes in the regulatory environment and related market practices that have driven up costs and uncertainty for emerging growth companies looking to go public to the point where most such companies began to position themselves for acquisitions instead.

Recognizing the dire implications for U.S. job creation and economic growth, Congress passed the JOBS Act 2012 to revive the U.S. IPO market in part by building the on-ramp by which small companies reached the public markets.

Now, a little more than a year after its passage, the urge to assess the impact of the JOBS Act by examining the state of the IPO market today is understandable.

In doing so, however, we must look at the entire picture and recognize the complexity of the factors at play in today's markets. When the JOBS Act was signed in April 2012, we assumed that any significant uptick in IPO activity would likely trail the law's implementation by at least a year or more.

A top line review of IPO market numbers since April 2012 confirms our assumptions. Only 49 venture-backed companies went public in 2012, which was 2 less than in 2011.

This year, only 8 such companies went public in the first quarter, however, the second quarter saw 21 venture-backed IPOs, bringing this year's total to 29 IPOs.

A year with 100-plus venture-backed IPOs would be considered a very strong year, so we are hopeful that this 20-plus IPOs per quarter momentum will continue because of the JOBS Act.

These numbers may seem underwhelming, but they reveal only a fraction of the impact the JOBS Act is having. It is estimated that a record number of companies are currently in registration for IPOs.

Since the law's passage, more than 500 companies have registered with the SEC as emerging growth companies. That is 77 percent of all companies who filed over this time.

Of these, 63 percent have used the confidential filing provision. In fact, it is estimated that a record number of companies, more than 200 in fact, are currently in registration for IPOs.

Finally, microcap IPOs, meaning firms with less than $250 million in market cap, have constituted 40 percent of IPOs so far in 2013 up from 21 percent in 2012.

Today, thanks to the on-ramp and other provisions, many companies are again committing to the time and resources required to explore IPOs as a viable option.

While the JOBS Act has reopened and smoothed the road to the public market for emerging growth companies, that market remains a very difficult place to grow a company. Today, market structures continue to favor the short-term, high-frequency trading of large cap stocks by investment banks.

In this environment, small stocks struggle to achieve visibility and liquidity. In the prior market era, small issuers could help support their stocks by publishing analyst research and employing market makers to spur interest among investors.

But current market economics no longer support these activities. This lack of information and liquidity has diminished the appeal of small cap stocks for investors.

Unfortunately, with all of these issues that we have discussed today, we don't believe there is a single simple solution to alter the current dynamics. With that being said, we are committed to working with a broad range of market participants to develop solutions that take all perspectives into account and that ultimately benefit all stakeholders.

Thank you for the opportunity to discuss these important issues with you today. I look forward to answering any questions that you may have.

[The prepared statement of Mr. Leach can be found on page 42 of the appendix.]

Chairman GARRETT. And I thank you for your testimony. Thank you for being on the panel.

Next, Mr. Moch is recognized for 5 minutes, and welcome to the panel as well.

STATEMENT OF KENNETH I. MOCH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CHIMERIX, INC., ON BEHALF OF THE BIOTECHNOLOGY INDUSTRY ORGANIZATION (BIO)

Mr. MOCH. Thank you very much.

Good morning, Chairman Garrett, Ranking Member Maloney, Vice Chairman Hurt, and members of the subcommittee.

My name is Kenneth Moch, and I am the president and CEO of Chimerix, a small, now publicly traded biotechnology company in lovely Durham, North Carolina. I am also on the board of the Biotechnology Industry Organization.

I want to thank you for the opportunity to speak about the pivotal role that the public market plays in financing the search for groundbreaking new cures and treatments.

Chimerix is a venture capital-backed company that went public in April of this year, and our offering was greatly enhanced by the IPO on-ramp provisions in the JOBS Act.

Leading up to the offering, we used testing-the-waters meetings to explore and evaluate the interest of potential investors. We were able to gather feedback on Chimerix and the interest of the potential public market investors that was critical to our decision to proceed with our IPO.

The testing-the-waters meetings also allowed potential investors to do their homework on Chimerix in the time between our initial meetings and the IPO. We were able to conduct literally dozens of meetings with potential investors which provided invaluable contact with the parties who later helped make Chimerix's offering a success.

I always say that biotechnology companies are research and development pipelines unencumbered by revenue. We conduct years and often decades of research and development and spend hundreds of millions and often over a billion dollars in investment capital before hopefully reaching FDA approval and generating product revenue.

As I am sure you already know, beyond and further complicating the sheer magnitude of investment is the risk of developmental failure due to the complexities of human biology.

Because of our unique business model, a successful IPO is of vital importance. Chimerix's offering allowed us to set aside the significant funding necessary to conduct a Phase III trial of our lead anti-viral drug candidate, CMX001, which is being developed to prevent life-threatening infections in immunocompromised bone marrow stem cell transplant patients.

In addition to the considerable benefits of testing-the-waters meetings, the 5-year SOX exemption allowed by the JOBS Act ensured that we will not waste valuable research dollars on unnecessary reporting.

It cost Chimerix over $10 million in legal, accounting, and ultimately banking fees to go public, and the temporary SOX exemption allowed us to focus those funds that we raised in our offering rather than preparing for 404(b) compliance.

I want to thank Congressman Fitzpatrick for introducing the Fostering Innovation Act to continue this important exemption for smaller issuers.

Spending investment dollars on compliance can limit R&D and delay R&D so changes like the on-ramp, Congressman Fitzpatrick's legislation, and Congressman Hurt's audit firm rotation bill are important for growing biotechs without product revenue.

I would also encourage the subcommittee to consider a small issuer exemption for XBRL reporting, which is a drain on both financial and personnel resources for growing businesses.

Compliance expenditures are a direct transfer of R&D dollars to auditing and accounting. For companies such as Chimerix that write a few thousand checks a year and have small accounting teams, this truly isn't a wise investment.

In the years since the JOBS Act was enacted, other biotech companies like Chimerix have seen the promise of the IPO on-ramp: 27 firms, merging biotechs, have gone public using provisions of the law—there may be a larger number now—and many more are on file with the SEC.

Congress now has the opportunity to ensure a positive trading environment for these emerging innovators through market structure reform.

Many small companies face liquidity and pricing issues that can be detrimental to their public float and cash flow. Market structure reform that addresses these issues could spur capital formation and support company growth.

I urge the subcommittee to address tick size flexibility as it considers market structure reform. A pilot program that allows—to allow small companies to choose a larger tick size for their stock would stimulate trading in growing businesses.

Decimalization has harmed liquidity for smaller issuers, and reforming the current one-size-fits-all tick size regime, which has been successful in other financial markets around the world, would grant flexibility to growing companies and increase the liquidity and capital availability necessary for emerging biotechs to be successful on the public market.

A functioning public market is vital to the success of the biotech industry and the American economy. At a time when venture capital financing of biotechnology is at a historic low and as an asset class truly appears endangered, the ability to access public capital is increasingly important.

We have seen the appetite for capital formation on the public market in the wake of the JOBS Act, and Chimerix was a clear beneficiary of that law; however, capital formation does not end with an IPO.

Congress has the opportunity to build on the success of the JOBS Act by exploring market structure reform to small-company growth in fundraising.

For growing biotech companies with voracious capital requirements, successful market structure reform would lead to scientific advancements, novel medicines, and life-saving treatments for patients in need.

Thank you.

[The prepared statement of Mr. Moch can be found on page 52 of the appendix.]

Chairman GARRETT. And I thank you as well.

Next up from KOR Trading, Mr. Nagy is recognized for 5 minutes.

STATEMENT OF CHRISTOPHER NAGY, PRESIDENT AND FOUNDER, KOR TRADING LLC

Mr. NAGY. Thank you.

Chairman Garrett, Ranking Member Maloney, and members of the Capital Markets and Government Sponsored Enterprises Subcommittee, thank you for inviting me to testify today on this important hearing on reducing barriers to capital formation.

My name is Chris Nagy. I have spent the last 25 years working within financial services on Wall Street. Coincidental with the passage of the JOBS Act, I left Wall Street and corporate America to found KOR Trading, a startup advocacy and consulting firm.

Secondly, I partnered with other entrepreneurs in another venture startup, PrairieSmarts, which will bring institutional quality risk metrics to individual investors, traders, and advisors.

As you know, when the JOBS Act was signed, specific mandates were assigned to the SEC to promulgate rulemaking; however, nearly 1 year after its passage, the SEC has not finalized these rules.

For many startups similarly situated like ours, Title II of the JOBS Act would open the doors to additional access to capital by allowing general solicitation and advertising to accredited investors.

We believe there is a much greater good by allowing more participation in capital raising for companies that are generating new jobs than the potential downside of an accredited investor losing money because of failed disclosure.

I am pleased to hear that the SEC is voting on Title II as I speak. Crowdfunding is an important source of capital for startup companies. It is early-stage firms like ours, which do not seek a great deal of capital, that often face the largest barriers.

We commend the House for allowing crowdfunding of up to $1 million in 12 months. In our case, it is not quite enough, but it is enough to get us up and running. These resources, however, only become available if and when the SEC finalizes the initial regulations.

We also expect to find further funding through the Small Business Investment Company program. Start-up businesses are hamstrung by the current profitability requirement when seeking SBA financing assistance.

We are very excited to be a part of the SBIC investment program in the fall of 2013, and believe it will be successful to expand the reach of assistance to startups like ours.

Title VII of the JOBS Act also requires that the SEC will conduct outreach programs and make information available to startups. I can tell you from my seat that I have yet to receive my information or outreach from the SEC on opportunities available under the JOBS Act and I would ask Congress to help the SEC along on provisions of the Act.

With innovation many times comes the ability to patent a product or an idea. The patent process is designed to protect that idea and give the initiator a competitive advantage in the marketplace.

Patent costs bear a considerable cost burden to the startup. Further, patent trolls lurk in the weeds waiting to jump on an opportunity to sue or potentially sue the startup which initiated the patent.

I ask Congress to examine this issue and seek ways to help protect startups from unnecessarily and many times frivolous litigation by requiring the initiator of such actions to bear all the legal costs.

We do support the initiative to seek widening spreads for small public companies. However, we feel that simply widening spreads may not achieve the full desired effect of increasing transparent liquidity provisioning.

We believe that in conjunction with a pilot, the SEC should seek to incentivize liquidity as was recommended by the joint CFTC–SEC Advisory Committee.

One such method would be the removal of Section 31 fees for small capitalized securities along with greater incentives to persons who regularly implement market maker strategies. We do believe that the balance has tipped in favor of dark pool operators, and we encourage the SEC to finalize its non-public trading rule proposal.

We also note that internalized payment for order-flow programs have increased and would encourage the SEC to consider a trade-at pilot in small capitalized securities. Other countries such as Canada and Australia have implemented rules regarding trade-at with good results.

Finally, we believe that the SEC should seek to fortify Rules 605 and 606 regarding execution quality. Greater transparency of order execution stimulates competition, keeps practices like payment for order-flow in check, and ensures that any pilot to widen spreads has empirical data behind it.

I am hopeful Congress can help push the SEC on its mission to finalize their tasks under the JOBS Act, and help entrepreneurs like myself become successful and deliver innovation and jobs to our capital market system.

Thank you for your time, and I am happy to answer any questions you have.

[The prepared statement of Mr. Nagy can be found on page 60 of the appendix.]

Chairman GARRETT. And, thank you very much.

Next, on behalf of the Investment Program Association, Mr. Souza is recognized for 5 minutes.

STATEMENT OF WAYNE G. SOUZA, GENERAL COUNSEL AND EXECUTIVE VICE PRESIDENT OF LAW, THE WALTON INTERNATIONAL GROUP (USA), INC., ON BEHALF OF THE INVESTMENT PROGRAM ASSOCIATION (IPA)

Mr. SOUZA. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee.

My name is Wayne Souza. I am general counsel and in-house executive vice president of law for the Walton International Group of Scottsdale, Arizona, and I am pleased to be here today to testify on behalf of the Investment Program Association (IPA).

The IPA was created in 1985 to serve as a national trade association for the direct investment industry.

Direct investment refers to the pooling of capital by individuals to make investments directly in tangible assets without taking on the responsibility of the day-to-day managing or operating of those assets.

Examples include non-listed real estate investment trusts, oil and gas and equipment leasing programs, and business development companies.

Direct investment products are designed to be medium- to long-term holdings, and because they are held for these longer durations they offer critically important capital in the form of debt investments and stable equity investments.

By the end of 2012, direct investments represented more than $1 billion in assets held in more than 1.5 million investor accounts with an average investment of $30,000. IPA members reported total sales of $13.3 billion for that same period of 2012.

Direct investments are a critical source of capital for America's small businesses. We are pleased to have this opportunity to discuss ways to reduce barriers to the capital formation and stimulate job creation for our fellow Americans.

We commend Congress, and of course the subcommittee, for the enactment of the JOBS Act last year. The Act included a number of provisions that will foster the creation of new businesses, as we have heard today, and the growth of existing ones.

The IPA would, however, like to suggest two clarifications to the JOBS Act in particular that are intended to make it even more efficient.

First, the Act makes it easier for private companies known as emerging growth companies to raise capital through an initial public offering.

The Act allows companies to test the waters, as we have heard, by engaging in communications with qualified institutional buyers and accredited investors without becoming subject to the requirements that apply to the prospectuses under Section 10(a) of the Securities Act.

However, in certain arenas, we have began to implement the JOBS Act and there have been many concerns raised as to whether these testing-of-the-waters materials are exempt from the requirements that apply to public offerings generally.

The lack of clarity in some sectors of the market is having a chilling effect on IPOs as companies may be reluctant to use the Act's provisions. The scope of the exemption should be made clear by Congress by amending Section 5(a) of the securities act.

Secondly, the JOBS Act requires the SEC to develop rules to ensure that securities sold by general solicitation or general advertising are sold only to accredited investors.

And subject to your comment this morning, Mr. Chairman, concerning the meetings currently being conducted over at the SEC, Congress should clarify that the Act neither requires nor permits the Securities and Exchange Commission to add requirements not found in the Act regarding disclosure or content standards in the very materials used for solicitation or advertising.

Beyond clarifying the JOBS Act, the IPA has two additional sections we believe would reduce barriers to capital formation. Business development companies (BDCs) are one of the fastest growing segments of the direct investment space and our membership at the IPA. BDCs are similar in function to venture capital and private equity firms, however, their ownership structure allows the general public to participate in them.

Currently before your committee are H.R. 31 and H.R. 1800, which would improve the ability of BDCs to provide capital to small businesses across this country. The Investment Program Association supports each of those bills.

A continuing challenge to our members is the patchwork of existing State laws that govern the acceptance of electronic signatures and executing security subscription documents. These different State standards slow down and even in some instances block the free movement of capital between regions.

We would recommend that Congress consider updating the securities laws to allow for acceptance of electronic signatures on security subscription documents in all jurisdictions.

Again, on behalf of the Investment Program Association, we appreciate this opportunity to address you. I will be happy to answer any questions you may have.

Thank you.

[The prepared statement of Mr. Souza can be found on page 64 of the appendix.]

Chairman GARRETT. And I thank you as well.

Finally, Professor Robert Thompson, professor of business law at Georgetown, welcome. You are recognized for 5 minutes.

STATEMENT OF ROBERT B. THOMPSON, PETER P. WEIDENBRUCH, JR., PROFESSOR OF BUSINESS LAW, GEORGETOWN UNIVERSITY LAW CENTER

Mr. THOMPSON. Thank you.

My thanks to you, Chairman Garrett, and to Ranking Member Maloney and the members of the subcommittee for the opportunity to testify about removing barriers to capital formation.

Even as we have seen the economy grow over recent reporting periods, the growth of capital formation, as measured for example by the number of IPOs, has been below some expectations.

The JOBS Act lowered a variety of barriers to capital formation and more are still coming in the regulatory pipeline. At the same time, innovations in the capital markets have also lowered barriers to capital formation and shifted how capital is raised.

My brief comments today will focus on those two topics.

JOBS added five deregulatory features to our national securities laws: two new exemptions, Crowdfunding and Regulation A-plus; revisions to a third exemption, 506, that will greatly expand its use; and then two major changes to the 1934 Act regulatory burdens, the on-ramp that has already been discussed and an increase in the threshold of Section 12(g), which quadruples the number of record shareholders before a company becomes subject to the 1934 Act reporting requirements.

As the three 1933 Act exemptions remain waiting rulemaking from the SEC and as 12(g), the effect will not be felt for some time, my focus today is on the fifth deregulatory feature, the on-ramp, where we have seen the greatest changes in the year since JOBS.

Most companies today, as has already been said, come within the definition of emerging growth companies and are eligible to use the detailed—less detailed regulatory requirements for up to 5 years after going public.

The first year of JOBS did not produce much difference from the period before JOBS in the number of IPOs, but we can see evidence that those companies that have chosen to go public are taking advantage of the reduced requirements for capital formation, although not in a uniform fashion.

A recent study by Latham and Watkins of the first year of JOBS shows a variety of taking advantage at different levels of different figures.

For example, starting at the top, nearly all emerging growth companies are using 404(b), the audit requirement exemption for their EGC period.

About three-quarters of emerging growth companies are taking advantage of reduced disclosure as to executive compensation. Almost half of emerging growth companies have provided 2 years rather than 3 years of financial statements.

One-third of emerging growth companies began filing with confidential submissions and many more of those are in the pipeline.

Only 20 percent of ETCs are taking advantage of the extended phase-in of accounting rules that could be put in place in the future, and there has been little use of the expanded definition of research that would allow borrowers communication with perspective buyers.

This diversity of EGC conduct in reaction to the new requirements is useful information both in terms of the provisions that they are adopting and also the ones that they see the benefit of continuing to make disclosures about.

Investors and issuers understand that credible information is essential to permit investors to accurately price their investments. The burden of increasing disclosure obligations on smaller public issues including the conflict mineral resources that the chairman mentioned at the beginning suggest the value of considering two levels of public issuers: one to whom all public disclosure rules will apply; and the other only applicable to larger disclosures that would cover, that go beyond shareholder interest.

The new Section 12(g) threshold which I described as having less of an immediate effect does impose one burden that merits current attention.

The threshold for being public which had been 500 shareholders of record has been changed to 2,000, but it requires that companies know who their shareholders are and not just their number of shareholders, but the number of accredited investors.

And they have to know that not just when they go public—not just at the beginning before they go public but every year until they go public.

This information 1 year into the new regime, the method by which companies will get this data remains unclear. Companies are very good at figuring out who their investors are when they issue stock to them in a 506 or some other private offering.

But as the years go by, they lose track of them. This is a burden that has not yet been solved. Congress needs to change the anachronistic of record label to something that is more suitable for the electronic age.

My last point relates to the fact that institutional shareholders are our shareholder base, and if we talk about barriers to raising capital, we need to focus on how institutional shareholders are different than individuals and some needs that they bring to the table.

Thank you very much, Mr. Chairman.

[The prepared statement of Professor Thompson can be found on page 72 of the appendix.]

Chairman GARRETT. And thank you, Professor.

And I thank the entire panel.

We will now go to questions, and I will first recognize myself for 5 minutes.

So, where should I start? Right in the middle.

Mr. Nagy, you mentioned one item that was of interest; unfortunately, it is outside of our jurisdiction, but still of interest to us is the patent trolls and frivolous litigation. So I will just make note that is something of interest to us, but I guess I will have to be put on another committee or something like that in order to deal with those issues.

But maybe you could go into an area you touched on that we do have jurisdiction on. From your experience and what you are looking at, the exchange is—so you laid out some of the problems, you laid out some of the things that Congress can be doing, can you lay out in the markets today, in the exchanges today, what are the participants on their own doing to ameliorate some of the problems that this panel has been looking at outside of Congress to improve in the area that we are looking at obviously trading in small cap companies?

Mr. NAGY. In terms of small cap companies, that is the problem.

Chairman GARRETT. Right.

Mr. NAGY. The volume just isn't there, so I would say, what are people doing? There has not been a lot done to really encourage robust liquidity in those names.

Chairman GARRETT. Okay.

Mr. NAGY. You have low trading costs and you have everything priced exactly how you have big securities priced, but what happens is particularly if you are a retail client or want to go in and buy the security you might see 100 shares offered—right—you want to buy 1,000 shares.

The next price point is going to be maybe $0.05, $0.10 up so there isn't enough liquidity to encourage somebody to even want to place an order to buy in a lot of those.

And I would say that is where the problem begins.

Chairman GARRETT. Right.

Let me swing over to the gentleman to your right, Mr. Moch. You laid out some numbers here which are interesting, the $10 million cost to go public in some of the problem areas which was 404(b).

Do you want to just comment on what the professor was talking about—from your view—as he put it, the diversity of the benefits by companies that they selected of the JOBS Act. You heard what he said. He just ran down how they were using it differently.

Mr. MOCH. Which particular aspect? I'm sorry.

Chairman GARRETT. So in other words, the professor was—and professor, you can chime in here—running through that we passed the legislation, it provided benefits, but apparently that the companies are looking at it from their own perspective, which is good, to pick out which ones best work for them, and you highlighted I guess in the one area, 404(b) as far as one of the benefits of being able to avoid that.

Mr. MOCH. Right. We spent about $1.8 million in fees before going public or as part of the process and then the bankers fees were another eight when we finally went public, and we were able to not—in the going public process, one of the things that was important for our investors was not to spend too much money before we found out if we could go public.

That is when the key things—by not having to be prepared for 404(b) compliance before the public offering, we can avoid that preparation, which is about tens of thousands of dollars. And if you look at it from—even hundreds of thousands of dollars—the venture capitalist perspective, you are putting more capital at risk for an event that might not happen.

So in a general sense, what we are trying to do is before we find out if we can even go public, not spend a lot of money getting ready for it. To be 404(b) compliant, for example, before a public offering requires you to be ready—get ready months if not years in advance and you can't make the decision of when the window is going to be available. So all of that spending money, basically transferring it from research and development to accounting.

Chairman GARRETT. Okay.

Mr. Souza, can you just elaborate a little bit on the disclosure requirements that you were talking about and the fact of whether or not to say—and I think I know the answer, but I will throw it out to you—as far as the SEC adding to or detracting from the disclosure requirements and the authority that they have in that area that you are talking about in your testimony?

Mr. SOUZA. Are you talking in connection with testing-the-waters?

Chairman GARRETT. Yes.

Mr. SOUZA. Yes. The best thing in our judgment as the association to remedy that situation is to borrow a piece out of Rule 408 in connection with free writing prospectuses.

In the area of free writing prospectuses, everything that is in the free writing prospectus need not necessarily go into the registration statement; absent which you would have material misrepresentation and the same thing we believe would be appropriate in terms of testing-the-waters.

That is, just because you may have some information in the materials one uses to test the waters and it is not in the registration statement, does not necessarily make it a material admission and remedying that would take care of that issue.

Chairman GARRETT. Okay, I think I got that.

Thank you. I appreciate it.

Mr. Scott, you are recognized for 5 minutes.

Mr. SCOTT. Thank you, Mr. Chairman.

Professor Thompson—incidentally I think all of you gave very, very good information, very good testimony—I just want to focus on three basic areas to get an ascertainment on and some of you may want to jump in, but Professor Thompson, do you have any significant evidence about the impact of the JOBS Act?

It has been a relatively short period of time, and in that time, have we given enough time for us here in Congress where we can get an impact on it before we even begin to think of what else we may want to do?

Mr. THOMPSON. As to the name, the hardest impact to measure is jobs. It is very difficult to have any metric to say we have produced jobs. As to—secondly, as to capital formation, which does lead to jobs, we can measure how much capital has been raised in the last year and there has been testimony from the panel about that already and it is going up. The second quarter has been very good, but still not so great.

As to the specifics, what I mention and the chairman referred to, it hasn't been one-size-fits-all. Companies that think about going public are looking at the JOBS Act and seeing what fits for them.

Section 404(b) is there for almost everybody, so you know that is making a difference. Some of the other things are not being used as much and that is worth taking into account, and then there are things like testing-the-waters that are by definition testing-the-waters goes on behind closed doors.

It is pretty hard for us on the outside to see what is going on, and the SEC is going to adapt as it goes along, so there hasn't been enough time yet to see exactly how that is working.

Plus, there is still more stuff coming online; 506 perhaps today, crowdfunding down the road, there will be other things going on, so we will know more than we know today and the question is, when do you know enough that you want to go ahead with something else?

Mr. MOCH. Would it be helpful to personalize that to Chimerix's effects—useful?

Mr. SCOTT. Yes.

Mr. MOCH. We absolutely use parts of the JOBS Act in our decision-making process to go public. We really started the process of going public a year ago; we went public in April, so the early part of last year.

We needed to raise money for a very expensive clinical trial, the drug I mentioned, CMX001, so we had to start talking to investors to see if they were interested and a year ago, there was no real public market. So today, yes, it is very nice. A year ago, it wasn't there.

So testing-the-waters was very important, and not having to spend money on something like 404(b) to get ready for a market which might not exist was critical to this decision-making process. Again, had there not been a public market, we would have been wasting money and time.

Mr. SCOTT. So the answer to the question would be that Congress might need more time to fully implement and evaluate the effects of the JOBS Act before pushing for any additional experimental, small business capital formation proposal. Is that pretty much the consensus of the group?

Mr. MOCH. Yes, but there are things you can already see to be helpful.

Mr. SCOTT. Okay, now I spoke earlier about are there any identifiable undue regulatory burdens that we need to look at that are standing in the way of capital formation?

Mr. Moch?

Mr. MOCH. I can certainly clarify—one of the comments was made about clarification of things like testing-the-waters meetings. This may be a minor part of it all, but I can tell you in talking to many other biotechnology CEOs, it is not clear how many people you can talk to, what you can or cannot leave behind, the depth of testing-the-waters meetings. So, every law firm gives a different piece of advice because there is no clarity.

Mr. SCOTT. Okay, I have 40 seconds left. What about the SEC program, the tick size, the efforts to make other moves? Each of these points that have been brought up with what the SEC is doing? What kind of grade do you give that? Are there alterations that need to be made in that?

Mr. Leach?

Mr. LEACH. I think the ideas that have been discussed today and in previous conversations about piloting whether it is on tick size or other issues are things that the committee should look strongly at and shouldn't wait because in many of these issues in terms of long-term economic impact are going to take years, not quarters to get the full understanding. So I think additional areas to consider should be looked at and tested and further discussed.

Mr. SCOTT. Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. Thank you.

The gentleman from Virginia, Mr. Hurt, is now recognized.

Mr. HURT. Thank you, Mr. Chairman.

And again, I thank each of the witnesses for being here.

I wanted to direct a couple of questions to Mr. Moch and your experience with Chimerix as it relates to XBRL. You noted in your testimony that the costs about $50,000 to comply with that. Could you talk a little bit more about that in terms of the ongoing—is that an ongoing cost?

And can you talk about the time that you are required—does that estimate include the time required by staff? Does that include the opportunity costs? That is, what could those resources be used for as it relates to other parts of your operation in how you invest those dollars?

Mr. MOCH. There are two sides to that. One, the number—you described it accurately—the $50,000 would include external costs to the printer if you will, plus the internal legal—internal costs of our staff plus legal oversight and review. So we estimate that at about $50,000 a year, which is, if you think about it, a person. So we are trading XBRL for a person.

Mr. HURT. Do you—and by the way, if I may interrupt, do you actually have one person who deals with that—

Mr. MOCH. No.

Mr. HURT. —or is that something that everybody has to—a number of people have to contribute to?

Mr. MOCH. We have a very small accounting staff who does—we have been audited by one of the major accounting firms through our life, but we have a small focused accounting staff.

The other side of it is the fact that most of the people who would look at biotechnology companies don't look at us quite bluntly for our financials; they look at us for the progress of our science.

And so the relevance of this rule to a company like Chimerix is one that I would question because it is not—they are not going to put our spreadsheet up and compare it to other biotechs. Let's put it that way.

Mr. HURT. Okay, that leads me to my second question. What does this do for investors? The investors who are looking to invest in your company, do you hear from them saying, what we see on this XBRL format is very, very helpful to us and this makes us want to invest in your company?

Is it helpful to them? And is there a risk of having it be actually not accurate or not helpful?

Mr. MOCH. I can't answer the second part. I can tell you I have never heard anybody ask about XBRL. I was also the CEO of one of the smallest accelerated filers in the country after the implementation of Sarbanes-Oxley in 2003, and never once despite the fact that we were fundamentally tortured by the compliance process, did an investor asked me about the status of our financials. It is all about the status of the science.

Mr. HURT. Very interesting.

Mr. Leach, I wanted to ask you about sort of the big picture in terms of the disincentives for companies to go public, and that obviously is something on which this committee is focused. How do we encourage more companies to do that?

That was the purpose of the JOBS Act. One of the things that you note in your testimony is that as a consequence, a lot of these startup companies are really positioning themselves to be acquired as opposed to going public.

Are there any negative consequences just to that dynamic in and of itself that a company is proficient need to go—to be acquired as opposed to going on its own and getting bigger? What are the sort of long-term applications for that, and are there negative consequences?

Mr. LEACH. There are very, very significant negative impacts on job growth. Obviously, when you are—in our case, a technology-oriented firm that is being acquired typically by a much larger company that has internal capacities that now are duplicative, those young companies coming to the larger firm and jobs are lost, not gained.

So this limitation and prevention of companies being able to access public markets has a very significant, negative impact on job growth and particularly—I am from Cleveland, so a place in the Midwest where there are lots of young startup tech companies.

A lot of the acquirers of these companies would be from outside the Midwest. So not only is it a negative national job impact, but the jobs could be polled to other markets, whereas in our community, we are really looking for young technology companies to be drivers of job growth. So this is a major impediment to the long-term trajectory of jobs in the United States.

Mr. HURT. Do you think that the XBRL issue that you all have touched on is—do you think that is in and of itself a disincentive or is it an example of the sort of a regulatory climate that is in fact of the disincentive to companies going public?

Mr. LEACH. I would say it is, but it is one of many. That certainly isn't the issue. I would also emphasize just because it has come up that the potential impact of crowdfunding, which is obviously for younger companies, earlier companies, than it is for firms that are preparing to go public, I think is also going to have an incredibly positive impact on job growth.

I know this committee certainly isn't losing sight of that, but it is a complex system. There are multiple levers to be pulled. All of them should be continued to be looked at and evaluated and tested for improvement.

Unfortunately, there is no silver bullet here, and that certainly is one of the challenges that this committee—

Mr. HURT. Thank you, Mr. Leach. My time has expired.

Chairman GARRETT. The gentleman yields back.

The gentleman from Connecticut is recognized.

Mr. HIMES. Thank you, Mr. Chairman.

I would like to thank the panel for a really informative discussion today on some fairly technical issues. I have two questions. One is, a number of the panelists made the point that one of the barriers to capital formation in the IPO market is the post-IPO trading environment, and absence of research coverage, and absence of market makers. There have been suggestions that there could be what feel to me perhaps heavy-handed mechanisms whereby we could address that. Of course, changing, mandating broader tick sizes is one of the proposals out there.

My question is, why does the market not take care of this problem? In other words, if you have illiquid lightly traded shares, why don't investors do their own work, because it's an illiquid inefficient market, they discover real value opportunities and therefore make a lot of money.

Why is there not a natural market solution to what appears to be an illiquidity problem in aftermarket trading?

Mr. NAGY. I can take that a little bit. Essentially, liquidity in our country has been boiled down to the top traded securities and furthermore, to exacerbate it, investors like you are talking about have moved from doing the research on individual securities more into exchange traded funds which happen to be based on those bigger securities as well, too, right, because they are worried about the market volatility.

When an investor takes a look at a very small capitalized security, they do not see a lot of liquidity there. There is no real incentive for them to want to buy it because it doesn't have the liquidity of the larger names that are out there.

So it is really important to push liquidity in those names and those smaller names also lack market makers and specialists to a big degree. There are a lot of firms that—

Mr. HIMES. But if I could interrupt there, isn't there just, if you do a $100 million IPO which is not an unusual size, there is just going to be a natural limitation on the liquidity.

A big institutional investor can't take a $200 million position in a $100 million IPO, right? Is there a solution to that problem?

Mr. NAGY. So what you are talking about is if you do a small IPO, and only have a set number of shares out there, you are going to have a small amount of trades per day?

Mr. HIMES. Yes.

Mr. NAGY. There is nothing you can do in that case, so you are talking about what the actual float is in the marketplace. If you have a small float, right, shares that are trading in the public marketplace, then you are going to have much lower volume, but the real question is not volume; the real question is liquidity.

So if I am an investor and I want to buy shares on a very low liquid stock, are there only 100 shares offered if I want to buy 1,000, 2,000, et cetera, at that price. I think that is where the real issue is and also one that drives potential investors away.

Mr. HIMES. Let me move on to my second question, because I will run out of time.

During the whole JOBS Act debate consideration, the amount of money we were talking about, 404(b) compliance and whatnot, it ranged from—some companies saying it costs them $500,000 a year and others saying $1.5 million a year. There was a big range there.

I was always puzzled by the fact that no issuer and the venture capital community never raised the issue of underwriter gross spreads, which 25 years ago when I was doing IPOs were 7.5 percent, and I think today are still pretty much 7.5 percent.

Mr. MOCH. Seven.

Mr. HIMES. Seven, okay, it has gotten a little more efficient there.

Doing my math, on a $200 million IPO, that gross spread is $14 million; much larger than the $0.5 million, $1.5 million annual we were talking about. And I understand that is an annual cost, but here is my question.

In that industry, the inputs have gotten much more productive; I.T., people, et cetera. Why in a purportedly competitive industry in which we have seen productivity improvements are issuers still paying roughly the same gross spread that they were paying 20 or 25 years ago?

Let me ask the professor and Mr. Nagy, who said he was on Wall Street for a while, to maybe start with answers to that question.

Mr. THOMPSON. That spread goes over the whole selling network. The core point, and it doesn't answer it entirely, is that when you do an IPO, you don't know what the price is. There has to be price discovery, and for price discovery you can't go to a market and watch it. You can't watch the tape. You have to talk to people. You have to—and you have to sense what they are doing and a middle man, a middle person does that.

And that process is still a—electronics hasn't helped us on that point as much as it has a lot of other things that we have done.

So I think there is still debate, but there is still a question that process has to have an intermediary who has a reputation on the line who is going to be able to come back and be a repeat player and who is going to be held accountable over the long haul for what they do.

And so, that is a cost of going public. It produces value beyond it because we see companies go public. But if it doesn't, companies will look for their money from venture capital to private equity or some other source.

Mr. NAGY. Yes, I would tell you that if you went back to work today it would be eerily similar in that regard, because the markets in that aspect haven't changed a lot from the underwriting aspect.

One of the things that has happened though over the past decade and a half is we have seen this decoupling of the distribution network versus the underwriting network. So back in the day when I first got into the industry, those were actually intertwined.

You had the distribution network coupled with the underwriting network and now that distribution network has been pulled out. We see that—in the form of online brokerages and where we see the investment thinking in the big banks. So there is a big decoupling there which doesn't allow those revenues to flow back and forth.

Just quickly, I was thinking about the last IPO that was done differently, Google, which did a Dutch auction out to their investors and there was a lot of criticism over the pricing of it. But it was fairly innovative in trying a different method for that.

So at the end of the day, the methods that are out there are still old. The market has changed quite a bit, and thus the reason why things are the same in that regard.

Mr. HIMES. Thank you, Mr. Chairman.

Chairman GARRETT. Sure. Thank you.

Mr. Huizenga for 5 minutes.

Mr. HUIZENGA. Thank you, Mr. Chairman.

I appreciate your time, and I know that especially for those of you from the private sector, this is taking away from some valuable time as you are out trying to grow businesses and that kind of thing, and it seems to me that this is a key element to our economic rebirth and our growth.

I come from a very entrepreneurial area over on the western side of Michigan, in the Grand Rapids area, and we have a lot of entrepreneurs, a lot of those small businesses, and I know they are looking for ways to take their ideas and move them to the next level.

I am concerned frankly that the SEC is spending more time and resources on discretionary issues, other things for example, the corporate political disclosure, Dodd-Frank rulemaking, the discretionary side rather than some of those more capital—I'm sorry, concrete measures that are going to help small businesses access that capital. I am kind of curious to get your temperature.

Absent of the JOBS Act, does anybody believe the SEC staff would have proposed any rules to the Commission to enhance capital formation, particularly small capital startups, private companies. Do we see that sort of a visionary movement out of the SEC or do we need to have a body like this to prompt them along?

Mr. NAGY. I will take that question. The answer is yes, you need a body like this to move them along. I would submit to you that it is interesting when you look at within the SEC some of the initiatives that they undertake.

I will give you an example. At no fault of theirs, it is just that the process to continue to move regulation that would. But I will talk about regulation SCI, Systems, Compliance, and Integrity, which was just proposed on March 8th. It actually goes back to an issue with a large market maker that happened in August of 2012, so I am drawing a timeline here.

So in August of 2012, you had an issue, a very large monetary issue with market maker on the street. On October 2nd, the SEC held a fairly large roundtable, and then on March 8th, the SEC proposed a 400-page set of rules regarding that issue.

Take that back to the JOBS Act—I said, I am a startup, I need crowdfunding to come in, we don't have anything on the table, it has been over a year, right. So I think it is a lot of where the priorities really are in terms of addressing the issues.

Mr. HUIZENGA. I want to say thanks for the answer, but that confirms something that I am not real thankful of, I guess, and that is a lot of the concern.

And I know that the SEC does the forum on small business capital formation and advisory committee. There has been a tremendous number of suggestions that have come out of that. I am not seeing a lot of implementation of that. Has anybody else seen what is coming of those things?

Professor?

Anybody else?

Mr. Souza is grabbing the microphone. Go ahead.

Mr. SOUZA. I happen to have the pleasure of serving as a securities subcommittee co-chair for the American Bar Association, and this topic came up at our very recent meeting. These forums have been continuing for some time at the Commission, but there appears to be a general market frustration about the implementation of positive or any actions in response to them.

Said another way, it is a good dialogue and it needs to take place, but there doesn't appear to be much movement following the meetings—

Mr. HUIZENGA. Not to interrupt, but are you saying actions speak louder than words?

Mr. SOUZA. Often, they do. Yes, sir.

Mr. HUIZENGA. Okay, all right. That is good to hear, and I know we had the pleasure of having Mary Jo White here in front of the committee. One of those recommendations—I have to put a plug in here for my bill, H.R. 2274, having to deal with mergers and acquisitions.

It seems to me as you are seeing a lot of those small businesses looking to move along they are going to have to sell themselves or at least part of themselves and there has been a real problem with the brokerage definitions of who that is and we are hoping to solve that with that particular piece of legislation. So I would love for you to take a look at that, H.R. 2274, you can write it down.

But I am also curious, is there anything else that we should be doing to help facilitate this, because this is so vital as we are trying to revive our economy? I am looking for suggestions.

Go ahead.

Mr. NAGY. I would just say that SEC funding is an important consideration, getting people to give the SEC the proper bandwidth that they need to be able to complete a lot of the rules.

Just visiting the SEC quite a bit, it was obvious they were bogged down from a lot of the implementation activities with Dodd-Frank. So a lot of other things went on the back burner which kind of makes it a little bit harder when they don't have enough staffing in place.

Mr. HUIZENGA. I appreciate it.

I know my time is up—maybe Mr. Moch, if the chairman will allow but it seems to me is about priorities as well, right?

Mr. MOCH. Yes. And I just wanted to add that, to reinforce the concept that one-size-doesn't-fit-all and that is really where we as a small company and over the course of my five companies we got hit with application of rules that are made for a bad act done by somebody in a very large company that then applied universally you to small companies. When we first encountered SOX compliance, the guys said look, I have to treat you just like IBM because that is what the law says.

Mr. HUIZENGA. Maybe we are here from the government, and maybe we can help, so we will try.

Mr. MOCH. It would be nice.

Mr. HUIZENGA. All right. Thank you.

And with that, I yield back. Thank you, Mr. Chairman.

Chairman GARRETT. The gentleman is recognized moving right down the aisle—

Mr. PETERS. Thank you, Mr. Chairman.

Chairman GARRETT. —for 5 minutes.

Mr. PETERS. I appreciate all of you being here, and your testimony, and I have a question really for the entire panel if anybody wants to jump in on this.

One suggestion of the SEC's advisory committee on small and emerging companies was the creation of a separate U.S. equity market specifically designed for very small and emerging companies.

Now as I understand it, several European exchanges created these types of so-called junior stock markets which were intended to promote equity finance by enabling small companies to go public and then to grow at that point.

However, in many of these new companies that initially went public, investor participation in trading volume shortly thereafter fell quite significantly, and by the mid-1990s, the European exchanges decided to abolish these junior stock markets.

So given that this is a recommendation from the advisory panel, could any of you comment on the European experience and how you think it might be different here in this country and make some sense for us?

Mr. THOMPSON. Not just Europe, but London and Brazil and other places have tried it. As the ranking member noted in her opening remarks, we have the deepest stock market in the world, and so that gives us more liquidity even in that segment, as well.

So there—in various—the experience might be different, but I think what the experience from the 1990s and 2000s shows is that the markets are creative.

The markets are adapting to changes in technology and changes in who is owning shares and the question is, who ought to be the lead for that question? Should it be the government or should be the markets? And on that question, I think there is something to be said for letting the markets take the lead.

Mr. NAGY. Yes, I would actually add to that, and I saw that recommendation of the advisory committee on small and emerging companies. The real question is if you do it, do you just have one, because I would like to put in the bid to be the one to run it, if that were the case.

So competition is always a good thing. There actually are facilities out there today. I do think once some of the provisions of the JOBS Act are completed, we will see markets begin to emerge naturally on their own that will begin to bring some transparency into the pricing of securities that are not yet IPOd.

Mr. SOUZA. I would observe for you that I think many companies are looking at the Toronto Stock Exchange to essentially do that in some form. They incubate there, they get a following and then they migrate to the larger exchanges in the United States and I have seen that occur a number of times. I am not suggesting that is the ultimate solution, but I have observed that.

Mr. PETERS. Okay, very good.

Thank you, and then a final question here to Mr. Leach.

I know you have had some success in nurturing startup companies in the Cleveland area, and Cleveland is a city that shares some of the challenges of a city that I represent, the City of Detroit, and I would like you to discuss some of the factors that you believe could help create a startup ecosystem in cities like Cleveland and how that might be transferable to Detroit.

Detroit, of course, has incredible intellectual capital. In fact, when the first patent office opened just a few years ago outside of

Washington, D.C., for the first time in history it wasn't opened in Silicon Valley, it was opened in the City of Detroit because of the incredible intellectual capital there, and yet we don't have the venture capital community in the City and in Michigan like some other areas.

Do you have some suggestions as to things that we should be doing that you would recommend?

Mr. LEACH. Absolutely. My organization is actually a nonprofit that partners with public, private, philanthropic, and institutional organizations that have a common vision to accelerate capital formation in the acceleration of young tech companies.

So the secret for us in Ohio, and we have actually worked now in 15 other regions of the country, is how do you bring together the leaders, the stakeholders who already have a vested interest in economic growth and particularly the acceleration of tech companies and help those leaders in that community figure out a strategy, a collective strategy that will leverage off and benefit each other?

We call it a collective impact strategy. There have been significant partnerships with Federal agencies as well as State and local governments, but more substantially, the private sector.

As a good example, my organization has invested $30 million of State and philanthropic monies in startups, in Cleveland—Northeast Ohio—and those startups have now raised about $400 million of private capital.

And along with that system, of those 70 companies that we have helped, we have also helped attract another $1.2 billion of private capital.

So for the places that aren't the usual suspects for this type of innovation, it really takes an all-in collective strategy, but most importantly tactics that institutions of research, the private sector, the corporate leadership, and the public sector can partner and of course the private sector can carry most of this weight if it gets some catalyst activity or momentum from the public sector in the philanthropic community.

Mr. THOMPSON. And don't forget the university segment in funding basic research that feeds into that same pipeline.

Mr. LEACH. Absolutely, absolutely.

Mr. PETERS. Thank you. Mr. Chairman, I yield back.

Chairman GARRETT. The gentleman yields back.

Mr. Royce?

Mr. ROYCE. Thank you, Mr. Chairman.

I was going to ask a question to the panel and this goes to the founder of the SUBWAY® Restaurants chain, who I saw make a comment to the effect that if he tried to start his company today, there would be no SUBWAY® because of, in his words, "more and more regulations."

And I saw that the National Federation of Independent Businesses had this study which purported that on a daily basis, there are 10 new regulations a day. Now ignorance of the law is no excuse, but clearly for small businesses, you have to stay abreast of all of these new regulations. You have to stay current. It has an amazing impact in terms of litigation costs and everything else as you are trying to deal with all of this in compliance.

I thought I would ask the panel what, if anything, could be done because if we start counting up the new regulations out of Dodd-Frank, all of the new regulations that impact litigation, all of the regulatory superstructure that is being erected and all of the ways in which small enterprises try to stay up with this, given their economies of scale, what might we be able to do to streamline some of this? Maybe get rid of some of the red tape, create a safe harbor in order to do startups, because this is where most of the new job creation is, isn't it, with starting the next little company and watching that grow and that is where the employment is created?

But, Mr. Leach, do you want to—

Mr. LEACH. Yes. It is a great question. The ideas of safe harbor's ideas and opportunities like that I think to be looked at. I think the reality for most small companies, certainly firms that are about ready to go public, absolutely, they have a good sense of the regulatory environment today are working in, but the reality is most small companies really don't, particularly in the earliest stages.

So to really have for small companies, small firms to have a better sense as well as Congress, the committee, and the citizenry of what are all of the regulations that are relevant to these businesses.

I think it is no one on the small business side. I think very few business owners have a full sense of—they are daunted by it, they are concerned by it, but we don't have a full sense of the balance of the things of that are in the short-term and intermediate best interest of small business owners that are on the positive and on the negative side.

I think it is just overwhelming for small companies today as they contemplate all of the different issues they are facing. So I think it is something that we need to get a much greater clarity on not only what is in place, but what could change to improve the situation for small companies.

Mr. ROYCE. I think a cost-benefit analysis on some of this would certainly be warranted if you consider how few people work. And of course once you have that small business that begins to take off, then you are in a situation as Mr. Moch, the company that went public under Title I of the JOBS Act, your firm, and I was going to ask you, Mr. Moch, because once you get some momentum in an enterprise, you have an idea that is really clicked, and as a consequence now you need access to capital to expand that company, I was going to ask you, was some of what we did in terms of the JOBS Act, is that what led you to choose this avenue for any merging growth company for your firm?

Mr. MOCH. To start off, our new company is actually already 10 or 11 years old and that is biotech drug development, and now only now going into Phase III.

Without the JOBS Act, it is an interesting question, and we were debating as a company what the course would be for us if the public markets were not open and we needed to raise $85 million to $100 million to run our Phase III trial, we would have had to do a private venture capital round.

The way venture capital works these days, because it is such a complex industry, is the new rounds coming in crush the old rounds, so the people who have been investors for 5 and 10 years would have had their returns crushed.

When they went out to raise their next round of venture capital because their returns were bad, the pension funds and others who look at the asset class of venture capital would have passed on it.

So there is a whole cascade of bad things that happen when public markets and financing markets don't exist and the existence of the JOBS Act and the ability to find out that yes, we could go public and we spent a lot of time talking to investors and bankers was critical because the alternative was a very difficult washout financing that probably would have crushed the prior investors and made this company, survivability would have been a question.

Mr. ROYCE. So after growing for 10 years to get to this point, the existence of the JOBS Act was then a critical factor in making you decide to access the public market and enter those public markets?

Mr. MOCH. Yes, and for other companies. I talked to a lot of other CEOs as well, and many companies are looking at, do they sell or do they try and do a venture round or do they try to go public?

If you sell a company, you cap the value and as was just mentioned by Mr. Leach, your company moves generally so their jobs are lost wherever you are.

If you have to do a venture round, you are crushed, and if there is a public market and we happen to—we spend a lot of time with the bankers and investors trying to figure that out.

People look at Chimerix and think that we helped open up this particular market, and I think that timing-wise we did, but without the ability to talk to everybody and make it happen, it would have been a very different outcome.

Mr. ROYCE. Thank you, Mr. Moch.

I thank the panel.

And thank you, Mr. Chairman.

Chairman GARRETT. Thank you.

The gentleman from Massachusetts.

Mr. LYNCH. Thank you, Mr. Chairman.

I want to thank the witnesses for helping the committee with our work.

Mr. Nagy, I was very encouraged by your statement regarding adequate funding for the SEC. I appreciate that. I am however concerned that the subcommittee's recommendation underfunds the SEC, underfunds the present request by $300 million, and I think that the added responsibilities that we have placed upon the SEC and Dodd-Frank and on the regulatory infrastructure cannot be met with the existing funding.

Professor Thompson, roughly 35 percent of all equities trading this year is taking place in dark pools or brokerage dealer internal pools of orders and other alternative training systems where prices are not publicly available in advance of the trade. They are only listed after trade.

Can you talk about the consequences of that? We are talking about capital formation and we see more and more trading coming off of the transparent exchanges and more energy, more resources, and greater risk being directed toward these dark pools.

What does it say if that trend continues with respect to the overall goal of enhancing capital formation, especially for some of the smaller companies that we are talking about coming into business at this time?

Mr. THOMPSON. Technology has really sped up the price of discovery process for any trader to the point that if you are a trader you are worried about entering into the market because the information is going to be—you are competing with someone who is having a different strategy and so you would rather be in a dark pool because you like the odds better of making money on your information.

And so, we have to deal with the technology part that is a reality that just speeds it up so much, and so, it is pretty complex. I don't have an easy answer for you, but there has been movement toward pushback on getting 2 second, millisecond advantages information before it is public, how to deal—because that is the kind of thing that drives you to a dark pool because you don't want to deal—you don't want to trade with someone who has an advantage over you and so it requires knowing technology and how that interacts with traders.

And that requires an expertise that doesn't usually exist in regulatory agencies or in the Congress and so it is a question of keeping up with technology and it continues to be a real challenge that the SEC is working on and we need to support them with having the guns to match what is going on in the private sector.

Mr. LYNCH. Thank you. Just a follow-up question: I know that we received some testimony at a previous hearing from Chairman Schapiro regarding the attitudes of investors with respect to companies that are required to comply with Section 404(b) versus the confidence level in companies that are not required to comply.

And I know that you have dealt with some survey information with respect to 404(b) compliance. Is there anything you can tell the committee with respect to investor confidence in terms of that compliance?

Mr. THOMPSON. There is a general correlation between information and investor confidence and there is a trade-off between cost and investor confidence.

I think the main point about JOBS is that emerging growth companies get 5 years of grace for 404(b), which is a large space to work out this cost point and to that extent, we can see how that works. Because we always have to balance the availability of information which usually helps consumers versus the cost of information to providers, but JOBS gives most companies, because remember most IPOs are emerging growth companies, it gets them 5 years of grace to get that sorted out.

Mr. LYNCH. Okay, thank you.

Mr. MOCH. May I—

Mr. LYNCH. Mr. Chairman—

Mr. MOCH. Can I just add to that—

Mr. LYNCH. Sure.

Mr. MOCH. —for the biotech industry, again, to be very specific where the lifecycle is so long and the probability of hitting revenue is often the future, even after 5 years, the applicability of the financial control that we are talking about in 404(b) isn't necessarily relevant because again, it is just a wealth transfer from R&D to accounting.

My first company, which I founded in 1982, didn't have product revenue for 15 years, but it was public in 1986. You have these long lifecycles before you have a dime of revenue. So the general one size you have to have it after 5 years may not work and probably doesn't in certain industries.

Mr. LYNCH. No, that is a great point. That is a great point. That is something we should be able to address.

I thank you, Mr. Chairman. My time has expired.

Chairman GARRETT. Thank you. The gentleman from South Carolina, Mr. Mulvaney, is now recognized for 5 minutes.

Mr. MULVANEY. I thank the chairman.

Gentlemen, I have a couple of different questions on a couple of different topics, so I will move through it as quickly as I can. I will open the first one up to just everybody which is: Several of you have mentioned in your testimony, both written and verbal today, that the SEC still has rules outstanding. If you had to pick one rule from the JOBS Act that the SEC had not yet enacted that you would like to see take a priority, what would it be?

Mr. Nagy, you mentioned, I think more specifically, so I will start with you, and then Mr. Leach, and I think Professor Thompson mentioned it as well.

Mr. NAGY. Without wasting your time, Title III.

Mr. MULVANEY. Title III?

Mr. NAGY. Yes.

Mr. MULVANEY. Mr. Leach?

Mr. LEACH. Crowdfunding; I think it will have a very significant impact, a positive impact.

Mr. THOMPSON. I would say 506, because crowdfunding, as it passed the Congress, put very serious limitations on how to draft a system that works. I still remain very skeptical about how they have been given a task to make crowdfunding work within the constraints of the bill is going to be a challenge.

506 can maybe make this happen already. It can happen, it will change capital raising immediately when that happens.

Mr. MULVANEY. Mr. Souza, do you agree?

Mr. SOUZA. Absolutely, 506, but perhaps we will have some greater clarity today.

Mr. MOCH. And from BIO's perspective, it is really Reg A.

Mr. MULVANEY. Okay.

Thank you, gentlemen.

Mr. Nagy, a question for you. In your written testimony, there is a line—and I will read it, it is only one sentence. It says, "Congress may want to consider permitting these firms," which you are talking about SBICs, "to become more involved in providing capital to financial service firms." That is currently the case. I have a bill that would allow BDCs to do exactly that. Could you tell us why you think that is important?

Mr. NAGY. Maybe it is a little self-interested, but we are what will be considered the financial services firm and there are quite a few out there. The SBIC program—

Mr. MULVANEY. But other than its benefit to your firm, how would it help access to capital?

Mr. NAGY. It would help to access capital simply because that program goes from—as it is today, you have to have net revenues, positive net revenues in order to receive money from that SBIC program.

The new program changes that in terms of you do not have to have net revenue; you don't need to be net revenue positive in that case, and I think that is really big. When you look at a startup coming in, the first thing they have are costs. Right? You have patent costs, you have hiring costs, you have developing costs. You are not bringing in any revenue because you haven't launched your product. Then, you have marketing costs on top of that, so you may not be profitable, as in our case, for 2 to 3 years.

Right? So, being precluded from that entire section of the market is very difficult. You have to go through different avenues to get funding in that regard which makes it harder.

Mr. MULVANEY. Mr. Moch, do you want to check in on that one?

Mr. MOCH. No, I was just enjoying being profitable for 2 to 3 years. Remember the unencumbered by revenue. My experience is 15 years on average is not before revenue, not profit.

Mr. MULVANEY. I have started companies and if we couldn't get net revenue positive in 6 months, we wouldn't have existed.

Mr. MOCH. My current company is about 200 and something million dollars of accumulated retained earnings negative. My last company that unfortunately didn't work because of how much money was lost was about $225 million before we started the drug wasn't going to work.

That is what this business, the biopharmaceutical business—

Mr. MULVANEY. That is a different world.

Professor Thompson, you mentioned in your testimony regarding an anachronism, that the concept of the on-record shareholdings is an anachronism. Any suggestions on what we could replace it with?

Mr. THOMPSON. Beneficial shareholders. Record shareholder refers to who is on the company's record and it is always a depository company. This was designed to solve the back office crisis of a generation ago.

When you go public, all shares are owned by a depository company or a broker-dealer. It measures nothing. If you do beneficial ownership, and computers let us do that, we get much more of a sense of who ought to be covered and who ought not to be covered. We ought to use beneficial owners only.

Mr. MULVANEY. That is the second or third time we have heard that as a constant theme in this committee, that this concept needs to go away and companies need to be able to know who owns them, and it is possible to do today where it wasn't in the past.

I was going to talk a little bit about the tick bill, but I understand Mr. Duffy is here, and he and my friend, Mr. Schweikert both have separate bills, so I am going to leave that to him and then close with you, Mr. Moch.

You mentioned that it cost you about $10 million to go public. Did you all have a feel for what that would have cost but for the JOBS Act?

Mr. MOCH. You could probably add a couple million more in terms of prep costs, so be spent again, $1.8 million of legal fees and accounting fees—I am sorry, $650,000 in D&O insurance which is required when you are public, but you could argue a million-plus more at risk for 404(b) preparation and other aspects of getting public in the old environment and that risk capital to venture capitalist is probably where we weren't willing to put it up.

Mr. MULVANEY. In the few seconds I have left, you also mentioned something that was very interesting to me, which is the percentage that you had to incur before you actually made the go, no go decision. Was that beneficially impacted by the JOBS Act as well?

Mr. MOCH. Yes, because we could feel the market. Early on, we could see the market interest. And I might add that by the way, other biotech companies—which we have looked at this number—we are low on the extent scale because I am a tightwad, but other companies going public have spent $3 million and $4 million to be—those are the costs of going public. So my $1.8 million is just low.

We are the third lowest out of 21 recent IPOs, to those $3 and $4 million and we certainly by knowing that there was interest in the market, we talked to investors, they would get feedback to the bankers, the bankers would tell us. We knew we had a path.

And the market was not open at the time we did this. So it is absolutely important for our decision-making process.

Mr. MULVANEY. Thank you, gentlemen.

Thank you, Mr. Chairman.

Chairman GARRETT. The gentleman yields back.

Mr. Foster, you are recognized for 5 minutes.

Mr. FOSTER. Mr. Leach, I guess, could you say a little bit more about the net job creation in an IPO versus an acquisition scenario? Because it seems to me that in an ideal market where everyone knows, everyone has complete information, the value of a startup might be higher in an acquisition scenario simply because redundant jobs can be eliminated and the merged entity would be a more efficient economic object. And that a lot of the increased value from—in the IPO scenario—has to do with the lack of complete information that you are introducing a much larger pool of less informed investors. And a lot of the increased economic value that is seen at the BC end and the startup end is due to the large pool of less informed investors. And where this is a fundamental tradeoff and—anyway, how do you see that whole—

Mr. LEACH. So today, approximately 20 percent of the U.S. economy is being driven by venture backed companies and as we discussed earlier, 92 percent of job growth is coming post-public markets. I think many of these firms have been industry creators. So as we look forward, what venture capital does is it invests in firms that create new industries as opposed to perhaps we are in more of a—we haven't had a dramatic new innovation in a—whether it is the Internet or biotech industry in previous decades that have been huge job creators and wealth creators going forward. I think that is an interim period where yes, M&A might have some greater efficiencies to the points that you raised, but looking forward, where the large—where I believe the large growth is going to happen is going to be from firms that are creating new innovations, whether that is out of things in the biotech sector, in genetics or other areas, those are going to be firms that if we are going to maximize the economic impact and potential of these new innovative firms, a more optimum approach would be to be able to access the public markets.

Today, the public markets are decreased or depressed mainly because there isn't confidence and access to it in the general downturn of the economy. So I understand your point, and I think there are some inefficiencies there, but looking forward, increasing access to the public markets is really what is going to enable these new innovative firms to create more jobs as opposed to more of an efficiency play which would occur more in the M&A space.

Mr. FOSTER. I come from the point of view of someone who started a startup with $500 from his parents that is now $150 million a year and it has been a very successful ongoing concern—when we had to grow, we simply brought in additional well-informed partners as investors and never were attracted by the public markets.

And it seems to me that there is some merit to having well-informed investors be the primary elements in this and avoiding the potential, the large number of the things you worry about on things like crowdsourcing when you are bringing in large numbers of less-informed investors.

And so I think we have to just be very careful that this is real economic value that we are optimizing for and not just transfer of wealth from a large number of less informed investors.

And a related thing, it seems to me that the issue of liquidity for small cap IPOs is a fundamental problem that I think Representative Himes touched on that the cost of obtaining information on a small cap object is relatively high.

You are never going to get—technical traders will not be interested in that because there are not a large number of competing, well-informed investors on these things because it is not worth their time. And so you are—I think you are never going to get larger volumes of technical trading and—or even a large number of well-informed investors.

And so I was just wondering if any of you can describe any scenario where we really have high true liquidity for small cap IPOs and then whether fixed size is really going to affect that fundamental problem?

Mr. NAGY. I can take that. When you talk about high and true liquidity for small cap security, when you look at many small cap securities today, they trade with large spreads. They are not trading at penny spreads, although we have a one-size-fits-all approach in the market. So they are bound by the exact same rules that the S&P 100 stocks trade by.

Now the disadvantage there is that when you look at that stock, you don't see a lot of size amount security. And I spoke about this before where you might see the offer side maybe 100 shares, the next level up might be a nickel or a dime up. When you look at an S&P 100 security, you are looking at a penny spread in that stock, hundreds of thousands of shares on each side.

If you widen the spreads, what you do is you encourage the liquidity provider to essentially commit more capital because they have carry costs, trading costs, everything else that goes in association with that, you encourage them to commit more capital for their implicit and explicit trading costs.

Thus, you go from 100 shares being offered at the inside to maybe 1,000, 2,000 shares being offered at the inside. That then incentivizes somebody who is looking at the stock to say, "Well, there is enough liquidity in it for my trade."

Mr. FOSTER. Who is the best entity to choose the tick size? Should that be the company or should it be rules-based? What is the best scenario for that?

Mr. NAGY. That is a really good question. The SEC held a roundtable, a decimalization roundtable late last year, and that was up for debate, should it be a nickel, should it be a dime? The JOBS Act amendments call for a dime.

Really what needs to happen and what is lacking in the market today is just empirical evidence. Do a pilot, figure out what the exact right amount is, and then perhaps apply that to different securities, different tiered securities. Other countries such as Canada and Australia, although they are far less liquid than the United States, all have tier sizes with their trades.

So if your stock price is X, then you trade at a different price, or if capitalization is X, you trade at a different price. That is really what has to happen. Any pilot needs to be followed up with empirical evidence to see whether or not it really made a difference.

Mr. FOSTER. Thank you.

I see I am out of time. I will yield back.

Chairman GARRETT. The gentleman yields back.

The gentleman from California has joined us.

You are recognized.

Mr. SHERMAN. It is always good to be as close as possible to the gentleman from Georgia.

The SEC advisory committee has urged that we not take into consideration policy objectives or humanitarian or social objectives. I would point out that they don't have the expertise to see what the effects are on the ground, particularly in Africa, and to weigh those with whatever inconvenience there is for the public sector companies.

I sit on the Foreign Affairs Committee and to think that we would diminish our efforts to deal with conflict minerals and that decision would be made on the basis of input from those who have not studied the conditions on the ground there does concern me.

A lot of the small companies were trying to get financing or spend money on R&D and under FASBR #2, Financial Accounting Standard Boards Release Number 2, they have to write it off. So if you build a laboratory, a building, and you capitalize that, it doesn't reduce your bottom line at all, but if you spend money inside that building, even if the research is successful, you have to list that as an expense.

Now if you are a real high tech high flyer company, investors recognize that, but we want research to be done by companies that don't have the word "research" in their name. To what extent are companies that aren't known for their research, that are companies where you buy on the basis of earnings-per-share, being discouraged from investing in research because it is an expense that hits the bottom line rather than a capitalized asset?

Does anyone have a comment on that?

Mr. NAGY. I will take a stab at it. In our country, we do a one-size-fits-all approach in the markets. So if you are a public company or a trading company, you pay the exact same price if you are a small company versus being a large company. Now if you look at just personal taxation, that is dependent upon the income that you—

Mr. SHERMAN. Mr. Nagy, I am not sure you understand my question. My question was about our accounting principles, which I think everybody agrees should be the same for large and small companies. I wasn't raising a question about taxation.

Mr. NAGY. Oh, sorry. Sorry, Congressman.

Mr. SHERMAN. Okay.

Does anyone else have a comment?

Next, one of the things—the really small companies, people who are seeing me every day in my district aren't looking to go public or even to talk to a venture capitalist. Their goal is to get a $1 million loan and they come to me, and they have talked to this bank and that bank and the other bank. To what extent would it help if we allowed credit unions to make business loans? Does anybody have a comment?

Mr. LEACH. My organization gets involved in a whole range of small business activities. Of course, the entities that we spend the majority of our time with are things that are ultimately venture-backed but there are real challenges in terms of access to capital in the traditional small business space as well and this is something that we see by the dozens every day and that is all of the options to accelerate the growth and the economic impact of small business Congress needs to evaluate and look at.

So specifically, to the credit union issue, I am not privy to the details of the regulatory issues there, but we still have real challenges on access to capital across all small business.

Mr. SHERMAN. Mr. Souza, you have members who are business development corporations. How would they be helped if we allowed them to issue preferred stock and that stock would count as capital in calculating their equity ratio?

Mr. SOUZA. I believe that would help tremendously, along with a number of other measures that are proposed in H.R. 31 and H.R. 800.

Mr. SHERMAN. I yield back.

Chairman GARRETT. Mr. Carney?

Mr. CARNEY. Thank you, Mr. Chairman. Thank you for having this panel today and thank you to each of the panelists. I have found your testimony today fascinating, very interesting. The JOBS Act, which I worked on with Members from the other side of the aisle—many of us did. This was the most productive work, I think, that we did in the last Congress, certainly in this committee.

We did it with Democrats and Republicans working together. I worked on the on-ramp part of the JOBS Act with Mr. Fincher so it is great to hear the testimony of Mr. Leach and Mr. Moch, in particular your willingness to come here and share your personal experiences is very, very helpful.

One of the things you said really, really hit me. You said you want to try to avoid all costs—I like the fact that you are a tightwad too, I try to be one; I am one of nine kids, so I think that is the source of it—you avoid costs before going public, an event that may not happen, and the preparation cost for the 404(b) audit you mentioned in particular was one.

You seemed to suggest a moment ago that maybe a 5-year on-ramp is not long enough, maybe for certain companies. Would you like to elaborate on that at all?

Mr. MOCH. Sure. The fact is that we have no idea when we will have revenue. It could be a couple of years or it could be another 5 or 10 years, and I have lived through that.

My last company—two companies ago called Alteon was 20 years old, never had a dime of revenue, but that is the lifecycle of biotech. Sometimes the drugs go quickly and sometimes they don't. Sometimes they fail in Phase III and you have another one.

So to apply a rule that says after a certain period of time, you have to comply with a rule which isn't really relevant to what people are interested in, just doesn't make sense to me.

Mr. CARNEY. So there are tradeoffs, as Professor Thompson mentioned.

Do you have a view of that, Professor Thompson, with respect to this particular sector and to the trade-off between investor confidence and information and cost?

Mr. THOMPSON. As to this sector—

Mr. CARNEY. Yes.

Mr. THOMPSON. —I think there is reason for a difference and so revenue may not be the right standard. And so you have to come up with a targeted language that would—because investors look at the science because there is no—why? Because there is no revenue to look at. So you look at the science and try to get your information from there.

But to me, it would be better—it would make more sense to try to develop targeted language as opposed to blanketly change the 5-year period.

Mr. CARNEY. So in other words, that would be directed toward this particular sector. That would probably be difficult to do, but maybe it is something we ought to take a look at.

Mr. THOMPSON. I think language could be developed that said if you get so much of X amount of your business is a drug development—I shouldn't be drafting for the industry.

Mr. CARNEY. So are there other costs that we should look at?

Mr. Leach, maybe you can answer this question. It is my understanding that most of the ideas for the IPO on-ramp evolved out of a meeting that started with Treasury and then an ad hoc group of industry participants and a series of ideas.

Are there things that are still out there that weren't in the original bill that we might take a look at?

Mr. LEACH. I can't speak to the specific gaps but there has been conversation both in the association and with venture firms. There are many ideas that I think can be brought to the table and discussed and evaluated to be able to reduce costs in this IPO on-ramp objective.

Mr. CARNEY. So you would be willing to share those with us?

Mr. LEACH. Absolutely.

Mr. CARNEY. That would be great.

Mr. Moch, is there anything in particular from the real-life that you would like to share with us and that should be a target for it?

Mr. MOCH. I don't have any specifics right now, although I know that BIO is working on a number, and I guess I will look to them to maybe provide some further insights.

I think that we did a pretty tough job of tightening down a lot of things and that was good, but there is still a lot of cost and there is still this huge uncertainty, so I am going to look to the BIO folks and we will—

Mr. CARNEY. So last question—I am running out of time—on tax reform and tax policy. Are those considerations anything that you look at, Mr. Moch or Mr. Leach, in the companies that you deal with?

Mr. MOCH. I really want to pay taxes someday.

Mr. CARNEY. Say that—

[laughter]

Good point.

Mr. Leach?

Mr. LEACH. Clearly, the importance of capital gains to the investment in early-stage companies. You are hearing the time horizons and that these investors are making 5-, 10-, 15-, 20-year time horizons, so to benefit investors who are willing to wait that length of time, capital gains are very important.

Mr. MOCH. Can an I speak for NDCA for a second?

Mr. CARNEY. Please.

Mr. MOCH. And I am not an NDCA person. I am critically concerned about the potential death of biotechnology venture capital investing. This is a tough, long-term asset class, and the changes in capital gains rates, and the complexities of investing in this business are such that the number of VCs focused on biotech is dramatically declining.

It is almost—it is in a crisis—from I think 150 or so even just a couple of years ago down to the 60s if I have that number correct now. So the feed stock of new drug development is drying up, and I don't know how you all face that and how you address it and what you do, but if you don't, the development of new drugs will ultimately decline even further.

Mr. CARNEY. Thank you.

Mr. MOCH. It is just that hard a business.

Mr. CARNEY. Thank you, all, very much.

I yield back.

Chairman GARRETT. I thank the gentleman.

And for the final word, Mr. Duffy is recognized.

Mr. DUFFY. Thank you, Mr. Chairman.

I want to join the committee in thanking the panel for taking time out of your days and providing such great testimony here today. I think it has been incredibly beneficial.

I think everyone on the panel and the committee understands that the largest creators of jobs in America are small businesses, and it has been those small businesses that are experiencing liquidity issues that are due to a number of things including changes in our market structure.

Since decimalization, all stocks operate under a one-size-fits-all trading regime. I think that has been beneficial to our larger, better known companies, but it has been detrimental to our smaller, less visible companies.

And to that extent, we have been talking about this, Mr. Carney and I have, introducing legislation that would offer tick-sized flexibility that would hopefully breed liquidity for, or help breed liquidity for our small cap companies.

There is a wide range of topics that we are discussing, but we are looking at tick sizes anywhere from—or increasing tick sizes from $.05 to $.10 allowing companies to choose that size which works best for them.

But with better liquidity, we think that we can see a growing economy, better job growth, and more opportunities for our American families. We think this is an important step in the right direction to address the problems that have been discussed here today.

And I guess, to this end, does the panel agree that one tick size doesn't fit all? Is there a consensus on that point?

Mr. LEACH. There seems to be.

Mr. NAGY. Absolutely.

Mr. MOCH. Yes.

Mr. SOUZA. Yes.

Mr. THOMPSON. Yes.

Mr. DUFFY. Okay, and that is a good starting point. I think it is actually pretty interesting that we have Democrats and Republicans, small businesses, and the SEC all agreeing that we need to have movement on this tick size issue.

Mr. Moch and Mr. Leach, how many analysts cover your stock, if any?

Mr. MOCH. We went public. Four companies currently cover the stock and this actually made me think of something that might be relevant.

In order to avoid some bad acts by a certain limited number of people multiple years ago, one of the rules that was promulgated by, I don't know if it was Congress or the SEC, was that analysts and bankers can't talk to each other ever because they will be shot if they do. And I think that from a standpoint of an IPO process, to go back to questions that have been asked, how can you make things better, I have to do double meetings with everybody. If I am talking to 20 banks, that is 40 meetings to try and get people up to speed, to have the bankers and the analysts make decisions independently because they can never talk to each other.

So if you want to find a moment in time where you might change something and allow the system to be a little more fluid, that is a moment in time. Yes, people did bad things years ago, but the whole industry and the IPO market is jammed up because of that.

So from the standpoint of analyst coverage, it is an incredibly difficult process because the bankers—the reason you want analyst coverage is so that people will follow your stock and the bankers don't want to cover a company where analysts don't like it, but they can't talk to each other.

So it is really made for a much more complex market that was done because one particular analyst did a stupid thing and made silly memos and I understand why you want to penalize that person, but it has penalized everybody.

So we have four right now. We will try and get more, but it takes a long time to work with the financial analysts. And that is the answer.

Mr. DUFFY. Mr. Leach?

Mr. LEACH. I have nothing significant to add to that. It is incredibly challenging.

Mr. DUFFY. How many companies?

Mr. LEACH. I am a venture capitalist, so I invest in small tech companies. No one follows us. In terms of our companies, they are all pre-public. So it is really not a relevant question.

Mr. DUFFY. Okay.

And I guess, Mr. Moch, would it be helpful if you had more analyst coverage? Would that be a benefit?

Mr. MOCH. Oh, yes. Absolutely.

Mr. DUFFY. If we get this tick size bill right, if we do this correctly, do you think that will foster more research in companies like yours, Mr. Moch?

And I don't know, Mr. Nagy, if you want to jump in on this too?

Mr. MOCH. I don't know a lot about the compensation mechanism for analysts, but certainly things that create greater liquidity—and if they choose a stock and say this is a good stock and people start buying that stock, I presume there is a mechanism by which the analyst get compensated.

I don't know that specifically. That is only good for increasing liquidity. It is self-fulfilling, right. People follow the stock, more people will follow the stock, people will get compensated, they will follow the stock. It is just a nice cascade up. We block that right now.

Mr. DUFFY. Yes.

Mr. NAGY. Yes, trading cost is absolutely a very important part of why a specialist or a market maker will engage in the stocks. So you can—if you can incentivize them and provide further incentives downstream, I think that is really important.

There are some proposals out there as well to allow companies to compensate, market makers to potentially compensate the analysts for coverage. I do think that is a workable idea and something that should be explored further.

Mr. DUFFY. And maybe on that point, if we get the tick size bill right, will that also encourage brokerage dealers to start making markets in smaller cap companies? Will that be a net benefit?

Mr. NAGY. Absolutely.

Mr. DUFFY. Okay.

Mr. NAGY. Yes, absolutely.

Mr. DUFFY. And just—I know my time is up—if I could ask just one quick question.

If no one is trading in companies like Mr. Moch's stock, or if there are stale quotes, who benefits?

Anybody? Do the investors benefit? Does the company benefit? Does society benefit? Does anybody benefit when no one trades?

Mr. MOCH. There is no liquidity and no trading? No, because the next time I try and raise money, I can't. Remember, an IPO is just the first step. It is not a destination. It is a milestone along a long pathway, a milepost along a long pathway. Our IPO is not the last time we are going to raise money.

If nobody trades in the stock, and some small stocks trade by appointment, then you can't raise the next round of money and then you are really trapped. So everything we can do to make sure the markets function fluidly will be important.

Mr. NAGY. It is also about proper evaluation. So the market finds the proper valuation many times of what that company should be trading and if you are very limited with coverage, liquidity coverage on that, that can affect your valuation.

Mr. DUFFY. And I guess as I am going to yield back in one moment—if any of you have any comments for Mr. Carney or myself in regard to what you would like to see in a tick size bill or not in a tick size bill, we welcome that input if you want to share it with our offices.

Again, thank you for your testimony, and with that, I yield back.

Chairman GARRETT. Did you have—I will just yield to Mr. Carney. Do you have any other comments with regard to that since you are working together on that?

Mr. CARNEY. No, I just want to thank Mr. Duffy for working with us—for giving me the opportunity to work with him, I should say, and any advice that you can provide for us, we want to try to get it right. The idea is to do a pilot. You all mentioned that and see what might happen.

Thank you.

Chairman GARRETT. Thank you, Mr. Carney.

Again, thank you to the entire panel for being with us today. It was, as a number of people have said, very helpful and illuminating.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

With that, this hearing is adjourned.

[Whereupon, at 12:02 p.m., the hearing was adjourned.]

APPENDIX

July 10, 2013

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

Subcommittee on Capital Markets and Government Sponsored Enterprises

"Reducing Barriers to Capital Formation, Part II"

July 10, 2013

Chairman Garrett, Ranking Member Maloney, my name is Ray Leach. I am the founding CEO of Jumpstart, Inc., a Cleveland-based nonprofit that builds partnerships amongst public, private, philanthropic and institutional organizations who are focused on supporting and investing in a diverse set of Ohio startup companies. We typically seek out high-potential startups who demonstrate the potential to create significant new jobs, wealth, collective economic impact and direct financial returns. Along with such partners as the Ohio Third Frontier, the Economic Development Administration and the Small Business Administration, JumpStart works one-on-one with entrepreneurs to assist them with critical business development activities including raising private capital, testing the commercial viability of their product or service and generating first revenues. While we have provided services to hundreds of Ohio companies, JumpStart has also directly invested $30 million into 76 Ohio startup technology companies which have gone on to raise more than $300 million in private capital and have created more than $1 billion in total economic impact in Ohio. In the process, these companies have created 2,000 total jobs and have generated millions of dollars of financial returns to date, which have then been reinvested into additional investing and support activities for entrepreneurs in Ohio.

I am also a member of the Board of Directors of the National Venture Capital Association, on whose behalf I am testifying today. Venture capitalists are committed to funding America's most innovative entrepreneurs. We work closely with them to transform breakthrough ideas into emerging growth companies that drive U.S. job creation and economic growth. According to a 2011 study by IHS Global Insight, companies that were founded with venture capital accounted for 12 million private-sector jobs and $3.1 trillion in revenue, or 22 percent in GDP, in 2010. Venture-backed companies also tend to generate more jobs and revenues than their non-venture peers. A recent study by the Institute for Exceptional Growth Companies (IEGC) and Pepperdine University's Graziadio School of Business and Management found that venture-backed companies generate 846 percent more revenue growth and 608 percent more jobs than comparable non-venture companies in the five years after they go public or merge with another company.[1]

Indeed, venture-backed companies are true drivers of the U.S. economy. That is one of the reasons why NVCA supported the passage of the JOBS Act of 2012 – and in particular, the "IPO On-Ramp" provision contained therein. My colleague Kate Mitchell, a former NVCA Chairman, testified before this very subcommittee in support of the bill in December of 2011. I want to thank this committee for its work on making the JOBS Act possible. I also want to thank the Members here today for continuing to direct their attention to regulatory and market concerns that affect companies once they have gone through an IPO. NVCA supports this continued focus on how to make participation in the public markets a better experience for small companies.

For this reason, I would like to take the opportunity today to provide you with an update on where the market for initial public offerings, or IPOs, stands from the venture capital

[1] http://bschool.pepperdine.edu/newsroom/wp-content/uploads/2012/12/Paglia-Harjoto-PE-VC-11.29.2012-IEGC.pdf.

perspective, and what effects the JOBS Act has had on the IPO market and for our portfolio companies.

The Value of IPOs to America's Innovation Ecosystem

To properly contextualize the importance of IPOs to emerging growth companies and the investors who fund them, I will briefly review the process by which venture capital guides and funds the growth of innovative startups.

Venture capitalists invest at the earliest stages of a company's development – often before a product or service is more than just an idea. This involves significant entrepreneurial risk, which severely limits capital sources for such companies. Yet, venture capitalists assume this risk alongside the company founders by providing capital in exchange for an equity stake in the company. During this investment stage, venture capitalists provide more than just money to the company. Typically, VCs take seats on the boards of directors and participate actively in company operations and management of personnel. This commitment includes providing strategic counsel regarding development and production, making connections to aid sales and marketing efforts, and assisting in hiring key management. As part of this process, the venture capitalist also guides the company through multiple rounds of financing. At each point, the company must meet certain milestones to receive fresh funds for continued growth.

The venture investor's goal is to grow the company to a point where it can go public or be acquired by a larger corporation at a price that exceeds the amount of capital invested. We call this process an "exit." Typically, when a venture-backed company exits the portfolio, the VC distributes the profits to the fund's investors, or limited partners, which most often are public employee pension funds, endowments and philanthropic foundations.

Of these two exit options, a successful IPO provides some important advantages over a merger or acquisition. First, an IPO typically raises more capital for hiring, product development and expanded distribution. Our data show that 92 percent of job growth from these firms occurs after a company goes public. In contrast, mergers and acquisitions often result in job losses, at least in the short term, as the acquiring company looks to eliminate redundant positions between the two enterprises. Second, an IPO enables all types of investors to participate directly in the company's growth as they look to build their portfolios and retirement accounts. It also provides financial benefits to employees of venture-backed firms who have also earned equity in the firm pre-IPO. Third, IPOs typically generate meaningful returns for the pension funds, endowments, foundations and other limited partners who have pooled their money with that of the VCs to invest. Lastly, a company that goes public has the potential to transform regional economies and communities in significant ways. Often, new innovation and entrepreneurship will "spin out" of these entities, creating an even more vibrant ecosystem in regions that otherwise would not be able to foster this growth organically. One only has to look to see what Medtronic did for Minneapolis, Dell for Austin, and Qualcomm for San Diego to understand why IPOs are so critical to these communities and regional economies.

The IPO Market and The JOBS Act Today

The decline of the U.S. IPO market over the past 15 years has been well-documented. From 1990 to 1996, 1,272 U.S. venture-backed companies went public on U.S. exchanges, yet from

2004 to 2010, only 324 did so. Most analyses have pointed to a complex series of changes in the regulatory environment and related market practices that have driven up costs and uncertainty for emerging growth companies looking to go public – to the point where most such companies began to position themselves for acquisitions instead.

Recognizing the urgency of this trend and its dire implications for U.S. job creation and economic growth, Congress passed the JOBS Act of 2012. A multi-faceted, measured and nuanced approach, the JOBS Act aimed to revive the U.S. IPO market in part by rebuilding the pathway by which small companies reach the public markets. It did so in three innovative ways: first, it recognized emerging growth companies (or EGCs) as a unique category facing acute challenges in accessing public capital. Second, it provided a limited, temporary and scaled regulatory compliance pathway, which the IPO Task Force referred to as the On-Ramp, that aimed to reduce the costs and uncertainties of accessing public capital. As part of this pathway, EGCs could file with the SEC confidentially and "test the waters" before going through with an IPO. Third, it intended to improve the flow of information to investors about the initial offerings for emerging growth companies, so that they would be easier to understand and invest in.

A little more than a year after its passage, the urge to assess the impact of the JOBS Act by examining the state of the IPO market today is understandable. In doing so, however, we must look at the entire picture and recognize the complexity of the factors at play in the markets today. We should also bear in mind that some provisions of the JOBS Act have yet to be enacted, and we encourage regulators to complete this important work.

When President Obama signed the JOBS Act in April 2012, the NVCA assumed that any significant uptick in IPO activity would likely trail the law's implementation by at least a year or more. Even with the On-Ramp provisions, the process of preparing to file for an IPO is lengthy and complicated. Many of our portfolio companies had already put themselves on the M&A track, and that course is not easily altered. We also assumed that continued uncertainty in the financial markets could further delay or suppress interest on the part of emerging growth companies in going public. While the markets appear to be in the midst of a sustained rally, this development is still somewhat recent.

A topline review of IPO market numbers since April 2012 suggests that our assumptions so far have been correct. Only 49 venture-backed companies went public in 2012, which was two less than in 2011. This year, only eight such companies went public in the first quarter. However, the second quarter has brought a significant improvement, with 21 venture-backed IPOs – bringing the year's total to 29. A year with 100 or more venture-backed IPOs would be considered a strong year, so we are hopeful that the pace of 20 or more per quarter will continue.

These numbers may seem underwhelming, but they reveal only a fraction of the impact that the JOBS Act is having within the small-company ecosystem. Since the law's passage, more than 500 companies have registered with the SEC as emerging growth companies. That is 77 percent of all companies who have filed over this time. Of these, 63 percent have used the confidential filing provision[2]. In fact, it is estimated that a record number of companies – more than 200, in fact – are currently in registration for IPOs. Finally, micro-cap IPOs – meaning those with less

[2] Source: Latham & Watkins Report (April 2013); Dealogic/NYSE Research, includes only companies who listed or filed to list on a national exchange.

than $250 million market cap – have constituted 40 percent of IPOs so far in 2013 – up from 21 percent in 2012.[3]

This surge of renewed interest in the public markets on the part of growing companies aligns with what my fellow venture capitalists and I see every day when we work with our portfolio companies. This contrasts starkly with prevailing attitudes among so many company founders and management teams just a few years ago. Back then, the obstacles on the way to going public, and compliance burdens they would incur if successful, hardly seemed worth risking their companies over. Today, thanks to the On-Ramp and other provisions, many companies are again committing the time and resources required to explore IPOs as an option.

For just this fact alone – the revival of interest in IPO market on the part of small companies – my colleagues and I consider the JOBS Act to be a major success. It remains an exciting first step on the path toward renewing the health and primacy of the U.S. public markets.

After the IPO

As the statistics suggest, many more companies are exploring the process of going public than are completing it. While the JOBS Act has reopened and smoothed the road to the public market for emerging growth companies, that market remains a very difficult place to grow a company.

Today's market structure continues to favor the short-term, high frequency trading of large-cap stocks by investment banks. In this environment, small-cap stocks struggle to achieve visibility

[3] Source: Dealogic, ECM Analytics. Renaissance Capital estimate

and liquidity. In the prior market era, small issuers could help support their small-cap stocks by publishing analyst research about the companies and employing market makers to spur interest among investors, but current market economics no longer support these activities. This lack of information and liquidity has made it difficult for investors who want to invest in small-cap stocks as part of a long-term, fundamentals-based investing strategy to justify buying small-caps at an IPO and holding onto them in the aftermarket. This development hurts small companies and investors alike.

We know that the committee is aware of these issues, and that a robust debate is already underway regarding what factors may be driving them. Each market participant sees these issues from their own perspective, and we support the committee's continued diligence in seeking out the full panoply of marketplace perspectives before considering any solutions.

As venture capitalists, we tend to see the markets through the eyes of our portfolio companies – even though it is most often the point where VCs exit the picture. From that perspective, we view the current market challenges within the context of one overarching question: how can we encourage more investors to buy emerging growth company stocks at the IPO and hold them for the long term?

Unfortunately, NVCA does not know the answer to that question yet. Nor do we believe that there is one single answer to it – or one single stakeholder who holds the key to providing it. What we do know, however, is that all marketplace participants must begin working more closely and deliberately together to find the answers – today. That's because the toll that the moribund IPO market has taken on our economy over the past decade – terms of lost innovation, lost job creation and lost economic growth – grows each day. And each day, our international competitors come closer to capturing what we are in the midst of losing – be it through market reforms, capital formation-friendly policies and incentives, or developing their own cultures of risk-taking and entrepreneurship.

That's why this footing of discussion that we have been on since the passage of the JOBS Act must move once again to a footing of action. We know from history that markets work best when they are vibrant and offer a fair shot to all participants. We also know from experience that when market participants work together as part of working groups, task forces and other similarly structured engagements, they can create the context for and generate the momentum toward meaningful legislation. That's what happened with the IPO Task Force in 2011 – in which NVCA played a critical role – and with similar groups, who ultimately helped provide the impetus for the JOBS Act. As the numbers suggest, that piece of legislation has done much to address the challenges currently complicating the first half of the IPO process.

Now market participants must turn our attention to the second half of that process: life as a public company. As was discussed at the recent Treasury Department conference on Access to Capital, we believe that participants from the entire capital markets ecosystem – not just the small- and mid-cap segments – must participate. Once again, NVCA will gladly lend its voice to the discussion.

We are confident that such a process can work once again. Despite the apparent fragmentation and divergence of interests prevalent in today's environment, all of these players still share one key incentive: building a healthy marketplace in which the greatest number of Americans can participate with confidence and trust.

Conclusion

The U.S. capital markets system remains the most powerful engine for capital formation in the world. However, the health and vibrancy of the IPO market plays a critical role in the long-term sustainability of that system. Therefore, we must continue to work together diligently to understand the challenges facing this critical market segment and engage in dialogue that can produce solutions that benefit all stakeholders. If we succeed in reviving the U.S. IPO market, we can re-energize U.S. job growth and ensure that new generations of innovative emerging growth companies will continue to grow into the leaders of tomorrow's economy.

In closing, I want to personally thank you for the opportunity to discuss these important issues with you today. I look forward to answering any questions you may have and, I thank you for your attention to this critical issue.

Biotechnology Industry Organization

Kenneth I. Moch

President and Chief Executive Officer, Chimerix, Inc.

On behalf of the Biotechnology Industry Organization

Before the United States House of Representatives Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises

"Reducing Barriers to Capital Formation, Part II"

July 10, 2013

Executive Summary

- Chimerix is a clinical-stage biotechnology company based in Durham, North Carolina. The Biotechnology Industry Organization (BIO) represents Chimerix and more than 1,100 innovative biotechnology companies, along with academic institutions, state biotechnology centers, and related organizations in all 50 states.
- Chimerix undertook a successful IPO in April 2013 using key provisions in the Jumpstart Our Business Startups (JOBS) Act. Twenty-seven biotech companies have taken advantage of the JOBS Act to go public, and many more are on file with the SEC.
- A healthy public market is key to the success of the biotech industry, as growing innovators often turn to an IPO to fund late-stage clinical trials. BIO supports targeted market structure reforms that will decrease the cost of capital and increase liquidity for emerging biotechnology companies trading on the public market.
- BIO supports the Fostering Innovation Act, which would amend the filing status classifications in SEC Rule 12b-2 to classify companies with a public float below $250 million or revenues below $100 million as non-accelerated filers.
- BIO supports tick size flexibility for emerging companies, which would increase small issuer liquidity and address the needs of growing businesses hamstrung by decimalization.
- BIO supports the Audit Integrity and Job Protection Act, which would prevent PCAOB from mandating that public companies periodically rotate their external audit firms.
- BIO supports a small issuer exemption from XBRL compliance, which stalls the development process by unnecessarily diverting funds to reporting and away from R&D.
- BIO supports effective and expeditious implementation of the JOBS Act, the capital formation impact of which has been blunted by delays at the SEC.

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Testimony of Kenneth I. Moch

Good morning Chairman Garrett, Ranking Member Maloney, Vice Chairman Hurt, and Members of the Subcommittee. My name is Kenneth Moch, and I am President and CEO of Chimerix, a small publicly-traded biotechnology company in Durham, North Carolina. I am also a member of the Emerging Companies Section Governing Board of the Biotechnology Industry Organization (BIO). I want to thank you for the opportunity to speak with you today about the pivotal role that the public market plays in financing the search for groundbreaking cures and treatments.

I have spent almost the entirety of my career in the biotechnology industry. I started working for a small life sciences consulting firm in 1976 and co-founded my first biotechnology company in 1982. During my career, I have worked with companies at all stages of the biotech life cycle, from venture-backed start-ups to later-stage public companies conducting costly and lengthy Phase III clinical trials with the hope of earning their first FDA approval. In large part, growing innovators are the heart of our industry. Chimerix has just 50 employees, which is typical for an industry where 90 percent of companies employ fewer than 100 people. These small businesses face a dual struggle – the daily challenge of running a growing company combined with the roadblocks intrinsic to groundbreaking scientific advancement. BIO represents hundreds of innovative companies like Chimerix, all of which must overcome capital formation barriers in order to fund their next generation R&D. The financing challenges that emerging biotechs face are unique, but when our industry is successful it has the potential to save lives and treat patients in desperate need of hope.

Bringing a breakthrough medicine from bench to bedside is a long and arduous process that often takes more than a decade and costs over $1 billion. In the biotech industry, we undertake this research process without the benefit of product revenue, so virtually all funding must come from external investors. During the early stages of R&D, private venture capitalists invest in promising companies, funding their initial studies, which include toxicity tests and the first safety trials involving human patients. As the research progresses and drug candidates show promise, further testing is required to show safety and efficacy in broad human populations. A single expansive Phase III trial can cost upwards of $100 million, to say nothing of the high risk (and, thus, the high likelihood of costs ballooning with additional tests and trials) at every stage of biotech research. With late-stage trials beyond the capital reach of private investors, companies entering their final stages of R&D often turn to the public market for financing, as we did at Chimerix.

The Jumpstart Our Business Startups (JOBS) Act

In the last year, the Jumpstart Our Business Startups (JOBS) Act has made the path to an IPO much smoother for emerging biotech companies. Chimerix went public in April of this year, and our offering was greatly enhanced by the provisions in the IPO On-Ramp. Leading up to the offering, we were able to use the "testing the waters" allowance in the On-Ramp to explore and evaluate the interest of potential investors, even before we filed our S-1 registration statement. Before the JOBS Act passed, we would have been forced into a quiet period as soon as we started preparing the registration statement, which would have meant a complete ban on contact with investors until the prospectus was made public.

Testing the waters made it possible to get the relevant facts in front of potential investors in order to generate interest in our offering. We were able to conduct literally dozens of meetings with potential investors in the months leading up to our IPO, which provided invaluable contact with the parties who later helped make Chimerix's offering a success.

The practical impact of these meetings was that the investors were able to do their homework on both Chimerix and their own portfolio in the time between our testing the waters meeting and the actual IPO. This flexibility allowed them to gather the information necessary to make an investment in our company. In addition, these face-to-face meetings provided our managers and directors with important strategic information regarding how investors viewed our business and prospects that informed decision-making with respect to not only the offering but our business in general.

In our roadshow during the 10 days prior to the IPO launch, we met with 16 parties who had participated in testing the waters meetings, of which 12 ended up making investments. This high conversion rate was due in large part to the success of the JOBS Act. All told, nearly half of the investors with whom we met during one-on-ones placed an order – fully two-thirds of whom had previously met with our team during the testing the waters period. By any measure, our IPO was a success, raising $118 million by selling 8 million shares priced in the middle of our proposed range.

Thanks to our successful IPO, we have been able to set aside the significant funding necessary to conduct a Phase III trial for our lead drug candidate, CMX001, which if approved by the FDA will help bone marrow stem cell transplant recipients fight off potentially life-threatening viral infections. In particular, this therapy is intended to combat virulent viruses such as cytomegalovirus, which is found in 65 percent of the U.S. population and can cause significant complications when the immune system is compromised or suppressed.

As we move forward with our work on this groundbreaking medicine, the IPO On-Ramp will continue to support our research. The five-year exemption from the burden of Sarbanes-Oxley (SOX) Section 404(b) will forestall the diversion of valuable investment funds from science to compliance. Because Chimerix will not have product revenue during our late-stage trials, we, like most biotech companies, must fund our R&D by raising investment dollars. If we were forced to spend that capital complying with the regulatory burden of SOX Section 404(b), it would slow our development process and increase the time it would take to reach important scientific milestones.

SOX requires an expensive external attestation of a public company's internal controls, which must be disclosed to investors on an annual basis. The true value of a biotech company is found in scientific milestones and clinical development progress toward FDA approvals rather than financial disclosures of losses incurred during protracted development terms. The business model of biotechnology is simple – we take in millions, if not billions, of dollars to fund our research and often do not earn a single penny in product revenue for more than a decade. Our science is the interesting part of our business, and it is the most important thing for investors to understand. At Chimerix, we strive to keep our investors informed of our progress, but wasting their valuable capital on government red tape instead of spending it on innovation and advancement does not serve their needs nor those of the patients who are waiting for our therapies. During the IPO process, the JOBS Act allowed us to focus on our offering rather than spend valuable time preparing financial statements for SOX compliance. Going forward, it will give us five years to spend time and capital on R&D rather than the onerous reporting burden of Sarbanes-Oxley.

In the year since the JOBS Act was enacted, other biotech companies like Chimerix have seen the promise of the IPO On-Ramp. Twenty-seven emerging biotechs have gone public using provisions in the law, and many more are on file with the SEC. This May was the best month for life sciences IPOs since 2000, with eight companies going public. (For comparison, there were only ten life sciences IPOs for the entire year in 2011.) Overall, IPO valuations of life sciences companies so far this year are up by 21 percent, on average, compared to 2012. This improved market for biotech offerings is due in large part to the flexibility allowed by the JOBS Act.

The JOBS Act could not have come at a better time for the biotech industry. Venture fundraising is at a historic low, as venture capitalists diversify their portfolios and turn away from the risky nature of investment in biotech companies. Venture investment fell by 10 percent from 2011 to 2012, and it was even worse for early-stage companies. A recent survey of VCs found that 40 percent plan to further decrease their biopharmaceutical investments over the next three years. The public market has always been key to the biotech life cycle, but depressed VC financing combined with the opportunity presented by the JOBS Act has made the current IPO window even more important for our industry.

As these newly public companies find their feet on the market, the five-year IPO On-Ramp will smooth their transition and increase capital availability for innovative research. However, Congress has the opportunity to do more to ensure a positive trading environment for emerging innovators. Once public, many small companies face liquidity and pricing issues that can be detrimental to their public float and cash flow. Without legislation to supplement the JOBS Act, emerging growth companies could be left to die on the vine, in reach of the vital capital available on the public market but unable to fully access it. I support targeted market structure reforms that will decrease the cost of capital and increase liquidity for innovative emerging biotechnology companies.

Tick Size Flexibility

The SEC adopted decimalization in 2000, changing the standard spread between bid and ask price (known as tick size) from 1/16 of a dollar (6.25 cents) to one cent, in an effort to increase trading activity for large issuers with millions of shares traded each day. However, as large companies enjoyed an influx of new investors, small issuers experienced a corresponding decrease in liquidity. Without strong liquidity available for small public companies, emerging biotechs can have difficulties raising the capital necessary to fund the decade-long, billion-dollar development timeline intrinsic to groundbreaking R&D.

Thinly-traded stocks, like those of most small biotechs, often need market-makers to stimulate trading activity, and the decreased tick size removed their incentive to do so. Market-makers profit on large spreads, so the reduced tick size diminished their potential profit margin, changing their market-making habits and leaving small cap stocks stagnant. The public market plays a vital role in financing next generation R&D, but a sluggish market bereft of liquidity does nothing to spur capital formation or fund research. The current one-size-fits-all approach to tick size does not reflect the realities of the market and subjects smaller issuers to the same trading framework as large, multinational companies with exponentially higher trading volumes and market caps.

I support flexibility in tick size for smaller issuers in order to address the needs of small companies hamstrung by decimalization. A pilot program to allow small issuers to choose larger trading increments (either \$0.05 or \$0.10) would spur trading activity in emerging company stock. A pilot program could be targeted at companies that meet a certain revenue, public float, or trading volume test – a revenue test is an especially important marker for growing biotechs that do not have product revenue to fund their vital research. Allowing an increased tick size would grant flexibility to growing companies and increase the liquidity and capital availability necessary for emerging biotechs to be successful on the public market.

BIO and I support tick size reforms that take into account the unique nature of the trading environment that small companies face as well as the high capital burden of biotech R&D. In order for any such measures to be a success, it is important that the increased tick size options apply to both trading and quoting increments. Allowing for tick size flexibility will increase the effectiveness of the public market as a capital formation tool and speed the development of cures and breakthrough medicines. As the JOBS Act continues to spur IPOs in the biotech industry, changes to the current one-size-fits-all trading regime must be made in order to alleviate the ongoing struggle to maintain healthy trading activity in small company stock.

The Fostering Innovation Act

As I have discussed, costly regulatory burdens have the potential to impede biotech research and delay the delivery of groundbreaking medicines to patients. Rep. Michael Fitzpatrick's Fostering Innovation Act would relieve smaller companies of the cost burden caused by Sarbanes-Oxley and other onerous regulations. The Fostering Innovation Act, which was approved by the Subcommittee on Capital Markets in the 112th Congress, would amend the filing status classifications in SEC Rule 12b-2 to provide a more accurate picture of the growing businesses that are weighed down by the various reporting requirements obligatory for public companies.

Because the filing statuses for accelerated and large accelerated filers under Rule 12b-2 carry with them onerous regulatory duties and compliance costs, finding a method of designation that fairly captures a company's profile is essential. The SEC understands that there should not be a one-size-fits-all approach to public company regulation, but the current filing classifications are outdated and do not reflect the true nature of many small public companies.

Currently, only those companies with a public float below $75 million are classified as non-accelerated filers. Despite their simple corporate structure and lack of product revenue, many biotech companies have a relatively high public float. Thus, biotechs often find themselves grouped with the accelerated filers and obliged to comply with the numerous regulatory burdens attendant to that definition, including SOX Section 404(b).

Rep. Fitzpatrick's legislation would raise the minimum public float requirement for accelerated filers to $250 million, classifying companies with a public float below that level as non-accelerated filers. This increase from $75 million to $250 million would allow start-ups to expand and change without fear of costly regulations impeding their growth. Many biotechs have public floats in or near that range, and the flexibility provided by the Fostering Innovation Act would allow them to focus on their innovative research rather than shifting funds to compliance costs.

The Fostering Innovation Act would also add a revenue component to the accelerated filer definition. Under the bill, accelerated filers would be described as those with revenues in excess of $100 million. Thus, any company with revenues below $100 million would be considered a non-accelerated filer as long as it did not cross the $700 million public float threshold and become a large accelerated filer. As I have mentioned, the most damaging facet of Section 404(b) for the biotech industry has been the diversion of investment funds from science to compliance in the absence of product revenue. Rep. Fitzpatrick's bill reflects this reality by classifying low-revenue companies as non-accelerated filers. If enacted, the Fostering Innovation Act would ensure that critical innovation capital is spent on groundbreaking research and development rather than regulatory burdens.

XBRL Reporting

Growing biotechs also face a regulatory burden in the form of XBRL compliance. Public companies are required to provide their financial statements in an interactive data format using eXtensible Business Reporting Language (XBRL). XBRL "tags" certain data points in an issuer's filing statement and exports them in a standardized format. The ostensible goal of XBRL is to provide more financial information to investors in a format that is easily comparable to other issuers' data. However, complying with XBRL places unnecessary burdens on emerging biotech companies.

In addition to instituting a new compliance burden for a small company's accounting department, XBRL is actually its own computing language – one that requires specific expertise outside the bounds of traditional financial or accounting training. Companies need experts in the XBRL language to properly file the appropriate reports, so small issuers turn to external contractors to complete their XBRL filings. The cost of an external XBRL contractor is significant for an emerging company, reducing the capital available for more vital functions like research and development. At Chimerix, we have estimated that compliance with XBRL will cost us approximately $50,000 annually. Those funds are investment dollars that will be spent on unnecessary accounting rather than vital scientific advancement.

Further, the information included in an XBRL report is often not indicative of the health of a smaller issuer. A biotech investor would be better served by comparing clinical trial results between companies rather than focusing on XBRL filings, which do not tell the whole story of a company's progress. Because XBRL reporting does not provide much insight for potential investors in small companies, the high cost of compliance far outweighs its benefits. BIO and I support an exemption from XBRL compliance for smaller issuers (or modified compliance, with exemptions from onerous detailed tagging), freeing them from a costly regulatory burden that does more harm than good.

The Audit Integrity and Job Protection Act (H.R. 1564)

In 2011, the Public Company Accounting Oversight Board (PCAOB) issued a concept release that, if adopted, would require that small public companies periodically rotate the external audit firm charged with verifying their internal financial controls. Such a change would place an undue burden on emerging biotech companies, who have few audit firms available to them and no product revenue to pay for expensive audit fees and other regulatory costs. Forcing small businesses to rotate their audit firm would increase costs as each new firm acclimated itself to the unique biotech business model, leading to a substantial diversion of capital from science to compliance.

The JOBS Act provides a five-year exemption from any such PCAOB requirement for emerging growth companies. However, the extended biotech development timeline often means that companies are on the public market for longer than five years before generating product revenue to pay for expensive compliance burdens. Reps. Robert Hurt and Gregory Meeks have introduced legislation, the Audit Integrity and Job Protection Act, that would prevent PCAOB from adopting an audit firm rotation requirement for any public company. I want to thank the House of Representatives for approving this legislation, as it will provide stability for growing biotechs funding their R&D on the public market.

JOBS Act Implementation

The IPO On-Ramp created by the JOBS Act has been a clear success for the biotech industry. As Congress moves forward with market structure reform, ensuring that the On-Ramp continues to benefit growing public companies is an important priority. Options to bolster the On-Ramp could include simplifying disclosure requirements for emerging growth companies or permitting confidential filings for follow-on offerings.

However, the majority of biotech small businesses are private companies. The JOBS Act included provisions to spur capital formation for these innovators as well, but delays at the SEC have blunted their impact. Over 70 percent of the biotech industry is private, so full implementation of the JOBS Act is vital for our industry. Although Chimerix is now public, we faced numerous fundraising challenges as a private company, and I believe that the reforms to Regulation D and Regulation A in the JOBS Act will support small company capital formation once they are implemented.

Biotech companies have expressed a particular interest in the changes to Regulation D that will allow general solicitation in Rule 506 private placements. The SEC issued a proposed Reg D rule in August 2012, and I am encouraged by recent reports that the Commission is planning to approve a final rule soon.

Even more delays have been seen with Regulation A reforms, which would permit direct public offerings of up to $50 million under a new Reg A+. There was no deadline for SEC action in Title IV of the JOBS Act, which authorized the Reg A changes, so the SEC has not made sufficient progress on the rulemaking process. BIO and I support Rep. Patrick McHenry's bill, H.R. 701, to institute a deadline for the SEC to implement Reg A+. The overwhelming bipartisan passage of H.R. 701 by the full House of Representatives sent a clear message to the SEC that action is needed to fulfill the full potential of the JOBS Act, and I applaud the House for taking that stand.

Biotech companies also benefit greatly from the JOBS Act's reforms to the Section 12(g) private shareholder rules. The exemption of employees from the shareholder limit gives private biotech companies the ability to hire the best available employees and compensate them with equity interests, allowing them to realize the financial upside of a company's success. This process could be further enhanced by amending SEC Rule 701 to increase the annual employee stock and options compensation limit (before triggering a set of disclosure requirements) beyond the current $5 million cap.

Closing Remarks

A functioning public market is vital to the success of the biotech industry and the American economy. At a time when venture capital financing of biotechnology is at a historic low, the ability to access public capital is increasingly important. We have seen the clear appetite for capital formation on the public market in the wake of the JOBS Act – and Chimerix was a clear beneficiary of that law. The rise in biotech IPOs in the last year is a clear indication that public fundraising is fundamental in the search for groundbreaking medical advancements.

However, capital formation does not end with an IPO. A healthy public market bolstered by strong small company liquidity and reasonable regulatory obligations will ensure the success of public financing throughout the decade-plus biotech development cycle. Congress has the opportunity to build on the success of the JOBS Act by enacting market structure reform legislation that will support small company growth and fundraising. Allowing tick size flexibility, reducing regulatory burdens, and addressing the broad portfolio of other market structure issues, including off-exchange trading transparency and high-frequency trading, will stimulate both trading and IPO activity and improve the overall health of the public market. For growing biotech companies, reducing barriers to capital formation on the public market would lead to scientific advancement, novel medicines, and life-saving treatments for patients in need.

TESTIMONY OF
CHRISTOPHER NAGY
PRESIDENT AND FOUNDER OF KOR TRADING LLC
AND COO - MANAGING MEMBER OF PRAIRIESMARTS LLC
BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES
HEARING ENTITLED "REDUCING BARRIERS TO CAPITAL FORMATION, PART II"
JULY 10, 2013

INTRODUCTION

Chairman Garrett, Ranking Member Maloney and members of the Capital Markets and Government Sponsored Enterprises subcommittee, thank you for inviting me to testify today on this important hearing to Reduce Barriers to Capital Formation; my name is Chris Nagy.

I have spent the last 25 years working within Financial Services on Wall Street. Prior to my current roles at KOR Trading and PrairieSmarts, I was Managing Director at TD Ameritrade, where I oversaw all aspects of Order Routing. I worked extensively with market makers and specialists and served on the boards of many of our nation's Stock Exchanges, with the sole mission of helping retail investors secure the best possible prices across markets for publicly traded companies. As a result, I have a broad and deep understanding of stock market structure and capital flows.

Coincidental with the passage of the JOBS act, I left Wall Street and corporate America to found KOR Trading, a start-up advocacy and consulting firm that helps exchanges and trading firms with market structure issues. Secondly, I partnered with other like-minded entrepreneurs in another venture start-up, PrairieSmarts, which will bring institutional quality risk metrics to individual Investors, traders, and advisors in a way never possible before. I thank Congress for its vision to harness the ingenuity of American workers like me in bringing innovation and job creation to the forefront; the passage of the JOBS Act was invaluable. Our continued concern is that the Securities and Exchange Commission "SEC" has not had the time to write the regulations that support the implementation of two very important facets of the JOBS Act.

I'd like to focus on my area of experience as the Managing Partner of a start-up venture. Therefore, I will not speak to Title 1 as it is one of the few pieces of the JOBS act that is operational (and from what I understand, quite successful). PrairieSmarts, our start-up venture, currently has four Managing Members and 1 associate and we project that by 2017 we will have more than 250 employees in newly created jobs.

As you know, when the JOBS act was signed, specific mandates were assigned to the SEC to promulgate rulemaking not later than 90 days after the date of enactment of the Act in several areas. However, nearly one year after its passage, the SEC has not finalized these rules.

Creating and running a start-up is no easy task. The basic building blocks are:

1. The entrepreneur (risk taker)
2. An outstanding product, service or idea
3. Market demand
4. Partnerships with the right people
5. Money.

PrairieSmarts is at the most critical stage of our business model: raising money to build the business. It is during these initial stages of business in which we are setting up the company, developing and testing the product, completing patent applications, establishing the marketing plan, that require upfront investment - and this all needs to be done pre-revenue. For startups like ours the initial stages are our most critical, but also where the greatest opportunity lies. Breaking down barriers to access capital is critical as financing at this stage often makes or breaks the viability and sustainability of the enterprise.

JOBS Act Title II

For PrairieSmarts and many start-ups similarly situated, Title II of the JOBS Act would open the doors to additional access to capital by allowing general solicitation and advertising to "accredited investors". Advertising in general is an important component of demand generation, which will help facilitate the raising of capital for start-ups, early stage companies, and emerging growth companies. We applaud this exemption to the SEC rules regarding general solicitation (public disclosure) and the required filings. Overall, we believe there is a much greater good by allowing more participation in capital raising for companies that are generating new jobs than the potential downside of an "accredited" investor losing money because of failed disclosure.

JOBS Act Title III

We feel Crowd Funding is an important source of capital for start-up companies. PrairieSmarts expects (and needs) to raise $2 million to build the business over the *next* 18 months. It is early stage firms like ours which do not seek a great deal of capital, that often face the largest barriers. (Many of you may be familiar with the phrase "Valley of Death"). A significant portion of the initial investment is in jobs. In our case, we expect to hire software engineers, customer services representation, operations specialists and others. We commend the House for allowing Crowd Funding of up to $1 million in twelve months. In our case it is not quite enough, but without question it is enough to get us up and running, and we expect to utilize this resource in the very near future.

But, as you know, these resources only become available if and when the SEC finalizes the initial regulations.

SMALL BUSINESS ADMINISTRATION INITIATIVES

We also expect to find further funding through Small Business Investment Companies (SBIC). In our minds this was a brilliant idea implemented by Congress. Start-up businesses are hamstrung by the current profitability requirement when seeking SBA financing assistance. Thanks to Congressional initiative, start-up, and small to medium size firms can access capital through Small Business Investment Companies. We are very excited to be a part of a SBIC investment program in the fall of 2013 and believe it will be successful to expand the reach of assistance to start-ups like ours. Congress may want to consider permitting these firms to become more involved in providing capital to financial services firms than is currently the case.

OUTREACH

Title VII of the JOBS act also requires that the SEC will "Conduct outreach programs and make information available to startups." I can tell you from my seat that I have yet to receive my information or outreach from the SEC on opportunities available under the JOBS act and ask Congress to help the SEC along on Provisions of Title VII of the Act.

LEGAL IMPEDIMENTS

With innovation many times comes the ability to patent a product or an idea. At PrairieSmarts we did just that. The Patent process is designed to protect that idea and give the initiator a competitive advantage in the marketplace. Patent costs are not cheap and bear a considerable cost burden to the start-up. Further, "Patent Trolls" lurk in the weeds waiting to jump on an opportunity to sue or potentially sue the startup who initiated the patent. Our current legal system requires that each side bear the attorney costs to fight what in many instances are frivolous actions brought by large corporations to stifle and drain the revenues of the start-up in hopes that they eliminate a competitive threat. While this Committee does not have the ability to change laws regarding legal actions against start-ups, I ask Congress to examine this issue and seek ways to help start-ups from unnecessary and many times frivolous litigation, by requiring the initiator of such actions to bear all the legal costs.

Requirements like these would significantly aid start-ups from unnecessary costs many times initiated by large companies to stifle competition.

STOCK MARKET STRUCTURE

We have ambitions to someday seek an IPO and publicly list within the US markets. In doing so we believe there would be merits to wider spread increments to facilitate larger pools of liquidity in the markets. We support Section 106(b) of the JOBS Act, the initiative to seek widening spreads for small public companies. However, we feel that simply widening spreads may not achieve the full desired effect of increasing transparent liquidity provisioning. While the SEC has delivered their report to Congress as required under the JOBS act, a pilot recommendation is overdue. We believe in conjunction with a pilot that the SEC should seek to incentivize liquidity as was recommended by the joint CFTC-SEC Advisory Committee following the market events of May 6th, 2010[1]. One such method would be the removal of Section 31 fees for small capitalized securities along with greater incentives to persons who regularly implement market maker strategies. We also believe that the balance has tipped in favor of dark pool operators and encourage the SEC to finalize its non-public trading rule proposal from 2009[2]. We also note that internalized payment for order-flow programs have increased dramatically over the past few years and would encourage the SEC to consider a "Trade-at" pilot in small capitalized securities as it will ensure that volume happens on our transparent exchanges. Other countries such as Canada and Australia have implemented rules regarding trade-at with good results. Finally, we believe that the SEC should seek to fortify rules 605 and 606 regarding execution quality, which today are severely outdated. Greater transparency with the quality of order execution stimulates competition, keeps practices like payment for order-flow in check, and ensures that any pilot to widen spreads has empirical data behind it.

I am hopeful Congress can help push the SEC on its mission to finalize their tasks under the JOBS act to help entrepreneurs like myself become successful and deliver innovation and jobs to our Capital Market System.

I invite Congress to follow PrairieSmarts as a real life example of a start-up. We expect to raise money through either Crowd Funding and/or the SBIC programs. We believe both programs expand access to invaluable capital. The JOBS act can help us (but to date has not helped us) as we progress to our goal and your goal to bring innovation and jobs to our great country.

Thank you for your time and I'm happy to answer any questions you have.

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[1] See: http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/jacreport_021811.pdf

[2] See: http://www.sec.gov/rules/proposed/2009/34-60997.pdf

Advocacy
Collaboration
Education

Advocating Direct Investments
Through Education

IPA
Investment Program Association

Written Testimony of
Mr. Wayne Souza
General Counsel and Executive Vice President of Law
Walton International Group

On Behalf Of
The Investment Program Association

July, 10 2013

Before the Capital Markets Subcommittee on Capital Markets
and Government Sponsored Enterprises

Hearing Entitled "Reducing Barriers to Capital Formation, Part II"

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Good morning Chairman Garrett, Ranking Member Maloney, and members of the Subcommittee. My name is Wayne G. Souza, and I am General Counsel and Executive Vice President of Law of the Walton International Group of Scottsdale, Arizona. I am pleased to be here today to testify on behalf of the Investment Program Association.

The Investment Program Association (IPA) was created in 1985 to serve as a national trade association for the Direct Investment industry. We offer leadership, education and advocacy services to more than 150 corporate members, who include securities product-offering sponsors, broker-dealers, and Direct Investment service providers.

"Direct Investment" refers to the business activity of individuals who pool their capital with other investors to make direct investments in tangible assets without taking on management or operational responsibilities. The IPA's members facilitate the transfer of capital between investor and business without the intermediary function of a stock exchange or bond underwriter. Examples of direct investment products include non-listed real estate investment trusts (REITs), oil and gas programs, equipment leasing programs, private placement securities offerings in real estate, and business development companies (BDCs), with BDCs constituting a fast-growing segment of the IPA's membership.

The vast majority of direct investment products are designed to be medium- to long-term holdings, and are therefore seldom traded as compared to various exchange-traded investments. Because they are intended to be held for longer durations, these products offer critically important capital in the form of stable equity and debt investments, reducing volatility in the marketplace. Direct investment products own dozens of types of tangible assets that touch the daily lives of Americans and facilitate job creation and retention. These investments are represented in the ownership of hotels, drug stores, skyscrapers, timberland, master-planned community developments, theme parks and senior living facilities, to name just a few. At year-end 2012, direct investments represented more than $100 billion in assets under management, in more than 1.5 million investor accounts, with an average investment of $30,000. The IPA's members reported total sales of $13.3 billion in 2012, with the vast majority of that, $10.3 billion, in non-listed REITs and $2.8 billion in business development companies.

My own organization, the Walton International Group, is a real estate investment and development company that focuses on the research, acquisition, management and development of real estate assets across North America. Our goal is to achieve the highest and best development potential of the land while maximizing returns for our investors. Walton currently manages more than $3.5 billion in assets, including more than 74,000 acres of land in North America, and our affiliates have managed privately offered real estate programs involving North American lands for more than 85,000 investors worldwide.

The direct investments facilitated by Walton International and the other members of the IPA are an invaluable and irreplaceable source of capital for America's small businesses, and that capital creates and sustains employment in America. Therefore, we are especially pleased to have this opportunity to discuss ways to reduce barriers to capital formation, and we applaud the Subcommittee for taking the time to consider this topic. No topic is more important to small businesses, which as you know are the primary source of new jobs in the U.S. economy.

The JOBS Act's Impact on Direct Investment

We commend Congress and this Subcommittee for the major work you have already done to stimulate the growth of small to midsized companies through the enactment of the Jumpstart Our Business Startups (JOBS) Act last year. The JOBS Act included quite a few provisions that will foster the creation of new businesses and the growth of existing ones, and facilitate the movement of capital within the marketplace.

Key provisions of the JOBS Act reduce unnecessary regulatory burdens on direct investment products and their providers, and make it easier for small businesses to find new investors and new sources of capital. Specifically, we applaud the creation of the new category of "emerging growth companies," with a streamlined route to initial public offerings (IPOs); the removal of the ban on general solicitation and advertising for certain offerings under Regulation D, Rule 506 and Rule 144A; the increase in the amount of capital that small businesses can raise without triggering the SEC's registration requirements; and the expansion of the number of shareholders a small business may have without being required to commence a SEC registration process. All of these provisions make it easier for small businesses to raise capital within their communities and from other interested investors.

In considering additional legislative changes to pursue those goals even further, the IPA can suggest some clarifications to these provisions that will make them even more effective.

Clarify the "Testing the Waters" Provision

Title I of the JOBS Act offers an "IPO On-Ramp" that makes it easier for private companies designated as "emerging growth companies" to seek capital through an initial public offering (IPO). The creation of this new category is a valuable change that will make new capital more readily accessible to thousands of growing enterprises.

Among the provisions that empower these emerging growth companies is Section 105(c), the so-called "testing the waters" provision. This section allows an emerging growth company or its authorized representative to engage in oral or written communications with qualified institutional buyers or accredited investors without becoming subject to the requirements that apply to prospectuses under Section 10(a) of the Securities Act.

As we have begun to implement the JOBS Act, however, it has not been sufficiently clear that these "testing the waters" materials used by emerging growth companies are exempt from the requirements that apply to public offerings. This risk is one of perception rather than reality, but the lack of clarity creates a chilling effect in the marketplace, as emerging growth companies may be reluctant to avail themselves of the Act's provisions.

Existing law offers a precedent for clarifying this perception. Rule 408(b) under the Securities Act of 1933 explicitly states that "the failure to include in a registration statement information included in a free writing prospectus will not, solely by virtue of inclusion of the information in a free writing prospectus . . . be considered an omission of material information required to be included in the registration statement." This provision clarifies that the information in a free writing prospectus is not necessarily identical to that in an eventual registration statement. Similar language applied to the "testing the waters" provision of the JOBS Act would reassure both emerging growth companies and the market, and encourage the use of this provision.

Clarify Provisions on General Solicitation and General Advertising

Title II of the JOBS Act required the SEC to develop rules to establish steps for issuers of securities to make sure that securities sold through a general solicitation or by general advertising are sold only to accredited investors. The Commission's rulemaking process has proven complex, and is taking considerable time to complete.

Certain members of the regulatory community have urged the SEC to include content and disclosure requirements as part of its rules governing solicitation and advertising to accredited investors. We respectfully submit that Title II of the JOBS Act grants the SEC no new authority to set content standards. In our view, the Congressional request was clear: the SEC is to establish steps by which an issuer can verify that sales of securities resulting from solicitation and advertising have been made only to accredited investors. The authority to impose these verification steps does not include the authority to impose content standards for solicitation and advertising materials. Congress should facilitate this process by clarifying provisions in Title II of the JOBS Act to make clear Congress's intent that the Act neither requires nor permits the SEC to adopt any disclosure requirements or content standards with regard to advertising and solicitation materials for accredited investors.

It might also be helpful for Congress to provide guidance on the disqualification and other treatment of so-called "bad actors" who violate these requirements under Dodd-Frank.

Reduce Compliance Burden on Business Development Corporations

One of the fastest-growing segments of the IPA's membership is business development corporations (BDCs), which are publicly traded and privately held private equity organizations that invest in growing US-based businesses. They are governed by the Investment Company Act of 1940. BDCs are similar in function to venture capital and other private equity firms, but their ownership structure makes them accessible to the general public, and allows them to offer small investors a way to participate in the capital markets. BDCs can play tremendously important roles in their community by moving capital quickly to businesses with urgent needs, as we saw the New York Business Development Corporation do in the wake of Hurricane Sandy.

A provision to streamline BDCs' registration statement filing requirements with the SEC, by allowing them to incorporate by reference from reports already filed with the SEC, would reduce duplication of effort and unnecessary regulatory burden. It would free up time, attention and compliance costs to make those resources available for additional support to emerging businesses.

We note that this suggestion is one of several provisions included in both H.R. 1800, the Small Business Credit Availability Act, introduced by Representative Michael G. Grimm, and H.R. 31, the Next Steps for Credit Availability Act, introduced by Representative Nydia Velazquez. This bipartisan legislation would give BDCs greater access to capital by amending the Investment Company Act of 1940 to allow BDCs to own investment adviser subsidiaries. It would also raise the reasonable leverage cap amount placed on BDCs, and would allow BDCs to count preferred stock as equity rather than debt in calculating total leverage. These changes, if implemented, would have the ultimate effect of enhancing a BDC's ability to raise funds and to lend or invest these funds to small and mid-size American businesses.

We further applaud several other provisions of H.R. 31/H.R. 1800, including the proposal to extend the definition of "well-known seasoned issuer" to include BDCs and the proposal to add registration statements filed on Form N-2 to the definition of automatic shelf registration statement, both provided by Rule 405.

Encourage State Acceptance of Electronic Signatures

A continuing challenge to our members as they try to match investors with businesses looking for capital is existing state laws that do not acknowledge the legitimacy of electronic signatures in executing the sale of certain securities products in all jurisdictions. While we recognize states' legitimate interests in these transactions, these different state requirements and in some cases prohibitions slow down and block the free movement of capital between regions. The 2000 Electronic Signatures in Global and National Commerce Act expressed the intent of Congress to utilize electronic signatures in the conduct of commerce. We recommend that Congress consider updating the securities laws to allow the acceptance of electronic signatures on securities subscription documents in all jurisdictions.

Beyond these recommendations, our members see many opportunities to facilitate and encourage capital investment through changes to the federal tax code. Although these changes fall outside this Subcommittee's jurisdiction, we look forward to opportunities to discuss these changes with individual members and the appropriate Committee in future.

Conclusion

Once again, I thank the Subcommittee for this opportunity to share the views of the Investment Program Association. Every day our members work in partnership with real estate developers and other small businesses to create economic opportunities in the communities where we live. We help individual investors put their money to work directly in their communities, and our business is built on trust and stability. We value our reputation for integrity and fair dealing, and we appreciate the work this Subcommittee is doing to promote the free flow of capital in our economy.

As you continue this effort, please call on us for additional information and support. We look forward to working with you. I would be pleased to answer any questions the Subcommittee members may have.

Statement of Robert B. Thompson, Peter P. Weidenbruch Jr Professor of Business Law, Georgetown University Law Center, before the Subcommittee on Capital Markets and Government-Sponsored Enterprises, Committee on Financial Services, United States House of Representatives

July 10, 2013

Thank you for the opportunity to testify today on the subject of "Reducing Barriers to Capital Formation." Even as we have seen the economy slowly strengthen over recent reporting periods the growth of capital formation, as measured for example by the number of Initial Public Offerings, remains lower than some expectations. The JOBS Act, effective 15 months ago, lowered a variety of barriers to capital formation with more reductions still coming in a longer than hoped-for regulatory pipeline. At the same time, innovations in capital markets have also lowered barriers to capital raising and shifted how capital is raised. My comments today will focus on those two topics.

JOBS added five deregulatory features to our national securities laws: two new exemptions from the registration provisions of the 1933 Act (crowdfunding and a new "Reg A+"), revisions to a third exemption (Rule 506) that will greatly expand its use by removing the ban on general solicitation, and two major changes to disclosure obligations under the 1934 Act-- the "on ramp" provisions that reduce the reporting obligations of an Emerging Growth Company ("EGC") as to more than a half dozen requirements and an increase of the threshold of section 12(g) that quadruples the number of record shareholders a company can have without being required to submit to the periodic reporting and other requirements of the 1934 Act (so long as those companies do not raise capital via an IPO or list their stock on a national securities exchange). The three 1933 exemptions await rule-making from the applicable agency, here the Securities and Exchange Commission (and two of the rule-makings have extended beyond deadlines Congress put in the statute), so that it is difficult as yet to evaluate the impact of those changes. The new section 12(g) always seemed likely to have its effect the longest time into the future, so that it is the fifth deregulatory feature—the on ramp--where we have seen the greatest change since JOBS.

Most companies going public today come within the definition of Emerging Growth Companies and are eligible to use the less detailed regulatory requirements for up to five years after they go public. These companies can initiate the SEC registration process confidentially and communicate with many institutions to test the waters as to buying interest. EGCs during the on-ramp period are exempt from internal control audits inserted by section 404(b) of the Sarbanes-Oxley legislation more than a decade ago, may disclose less in the way of financial data in general and executive compensation in particular, and may use longer phase-in periods for new accounting standards.

The one year anniversary of JOBS spurred multiple analyses of its impact. Measuring jobs that can be tied to an IPO has always been a difficult metric to develop and the first year experience leaves that discussion on going. As to the number of IPOs themselves, the first year didn't produce much difference from the period before JOBS, even though the economy has gotten better. But we can see evidence that those companies who do choose to go public are taking advantage of the reduced barriers to raising capital, although not in a uniform fashion.

One examination of EGCs filing a public registration and pricing in the first year after JOBS found the following pattern in use of the on ramp provisions:[1]

- Nearly all EGCs indicated an intention to take advantage of the section 404(b) exclusion during their EGC period;
- About three quarters took advantage of reduced disclosure as to executive compensation;
- Almost half provided two years rather than 3 years of financial statements (the number drops to 30% of those who had at least three years of financial data to report; of the half that reported three years of data, 1/3 provided less than the usual 5 years of selected financial data);
- One-third of EGS filings began with a confidential submission to the SEC (and a similar number of firms publicly in registration but not yet priced had previously submitted at least one registration for confidential review);

[1] Latham & Watkins LLC, The JOBS Act After One Year: A Review of the New IPO Playbook (April 5, 2013). Of 500 issuers identifying themselves as EGCs who publicly filed registration statements in the first year after JOBS (as of March 31, 2013), the study reviewed 184 issuers that either successfully completed an IPO listing on a major U.S. securities exchange or who the study's authors believed would be likely to complete such an IPO. Most of the data here report on the 101 EGC offerings that had been priced (i.e. successfully completed) as of March 31. About three-quarters of issuers that priced an IPO in the first year after JOBS identified themselves as an EGC.

- Only a minority of firms indicated a choice to take advantage of extended phase in of accounting rules that might be put in place in the future (i.e. 80% of EGCs would be subject to these changes from the time they become effective).

JOBS also loosened the regulatory bite as to restrictions on issuer communications with prospective buyers. The statute's broadened definition of research that would be permitted in communication with purchasers does not seem to have yet changed behavior except perhaps for expanding publishing of research reports before and after the expiration, termination, or waiver of a lock-up agreement between the underwriter and the company or its shareholders.[2]

The diversity of EGC conduct in reaction to the new freedoms provided by JOBS is useful information, both in terms of provisions that issuers believe are most onerous, and the disclosures that they see benefit in continuing to make. Investors and issuers understand that credible information is essential to permit investors to accurately price their investments. The burden of increasing disclosure obligations on smaller public issuers (including items like conflict minerals) suggest the value of considering two levels of public issuers, one to which all disclosure rules would apply, and the other that would apply to larger issuers for which public expectations are greater and extend beyond shareholders.[3]

The new section 12(g) threshold, which I described earlier as having less of an immediate effect, does impose a bite that merits current attention. The threshold for staying private, which has long been based on having less than 500 shareholders of record, now requires companies to know the number of accredited investors (.i.e. less than 2000 shareholders of record if no more than 499 are non-accredited), and know that on an annual basis. One year into the new regime, the method by which companies are going to make this determination remains unclear. Issuers are used to determining who is accredited at the time that they issue stock to them pursuant to specific exemptions, but doing so on an annual basis thereafter when financial reversals may have occurred to some investors and others may have drifted away will create the need for a more intense ongoing relationship between issuers and

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[2] Id at 17.

[3] Along with Professor Donald Langevoort of Georgetown, I have written about this possibility in *Publicness in Contemporary Securities Regulation after the JOBS Act*, 101 GEORGETOWN L. J. 337 (2013). We have focused on the 1933 Act aspects of JOBS in *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising* in 98 CORNELL L. REV. (forthcoming 2013) available at http://papers.ssrn.com/so13/papers.cfm?abstract_id=2132813.

their shareholders than we have seen before. The movement of "record" title to securities from individual, beneficial owners to centralized intermediaries such as broker-dealers or various depository entities can reduce this problem but that move typically has occurred at the time that firms go public and this requirement is going to hit firms well before that point. It is time for the Congress to move beyond this 50 year old anachronistic concept of "record" ownership, first inserted into the statute when stock transfers could only occur by written instruments and adopt a concept more suitable for an electronic age.

The changes to Rule 506 removing the long-standing limitations on general solicitation, (once they take affect after completion of SEC rule-making) are likely to expose the definition of accredited investors to additional stress. The expansive part of this definition takes in individual investors based on financial thresholds that have not changed since 1982, despite three decades of inflation. Being able to market to investors with $1 million in net assets and more than $200,000 of annual income goes much deeper into the investor pool than it did thirty years ago, such that a modern look of that definition is needed to bring that metric current.

While the changes in regulatory coverage have eased the burdens on raising capital in substantial ways, the impact of market changes may be even more dramatic. For example, holders of stock not traded on national exchanges can find more liquidity for their investments than ever before in platforms like SecondMarket and SharesPost. As a result more firms can stay outside thresholds triggering public reporting status longer. Recent data indicated that the amount of money raised in private placements ([particularly rule 506) have surpassed the amount raised in registered public offerings.[4] This pre-dates recent regulatory changes and likely reflects the changes in the financial market that have permitted companies to raise more of their capital needs from private funds and venture capital without going to a registered offering, again postponing their exposure to public company regulation. This shift does not do as much for small start-ups, for which continued focus of crowdfunding and other developing ideas should be pursued.

[4] See VLAD IVANOV & SCOTT BAUGUESS, CAPITAL RAISING IN THE U.S.: THE SIGNIFICANCE OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION (February 2012) at 3, available at http://www.sec.gov/info/smallbus/acsec/acsec103111_analysis-reg-d-offering.pdf (SEC economic study showing Reg D in 2010, even before dropping the ban on general solicitation produced 8% more capital than public offerings).

When considering the effects of market changes on capital raising, one change that has not received the attention it deserves is the institutionalization of our shareholder base. In contrast to 1950, for example, when the institutional share of equity in American corporations was in the single digits, today institutions hold the majority of equity and in our largest corporations their share exceeds 70%. Institutions are also a significant share of the IPOs market. Most of institutional money, in turn, comes from various instruments for retirement savings that receive tax- favored treatment under our laws; thus most equity owners are intermediaries for beneficiaries whose retirement funds are on the line. For a substantial segment of these funds, there are additional layers of intermediation with institutions providing significant sums of money to asset managers and hedge funds who then invest in equity and elsewhere. A focus on reducing barriers to capital formation should take explicit account of the extent to which intermediaries are the investors providing the capital and how that shapes barriers to investments.

Question for the Record
Representative Gwen Moore
Subcommittee on Capital Markets and GSEs
Reducing Barriers to Capital Formation
July 10, 2013

Mr. Moch, thank you for your testimony.

Please expand on the proposals for a tick size pilot program as a way to encourage small- and medium-sized businesses to go public, to create jobs, and to stimulate the economy. Specifically, please describe (1) why you would support a tick size pilot program, (2) how such a proposal would increase liquidity in small-capitalization stocks, (3) how a tick size pilot program would benefit investors, and (4) parameters you believe are essential to a pilot program, such as a minimum pilot program length and a "trade at" rule that would eliminate trading rebates within the spread and require trading at the tick increments.

In addition, during the hearing one witness stated that given the long-term impact to the economy the committee should not wait to take action. Do you recommend that the SEC move forward with the tick size pilot program before the end of the year? In the absence of SEC action, would you support congressional legislation?

Why would you support a tick size pilot program?

Thinly-traded stocks, like those of most small biotechs, often need market-makers to stimulate trading activity, and the decreased tick size enacted by decimalization removed their incentive to do so. Market-makers profit on large spreads, so the reduced tick size diminished their potential profit margin, changing their market-making habits and leaving small cap stocks stagnant. The public market plays a vital role in financing next generation R&D, but a sluggish market bereft of liquidity does nothing to spur capital formation or fund research. The current one-size-fits-all approach to tick size does not reflect the realities of the market and subjects smaller issuers to the same trading framework as large, multinational companies with exponentially higher trading volumes and market caps. A tick size pilot program would address the harm that decimalization has caused for small cap stocks and stimulate liquidity for growing companies.

How would a tick size pilot program increase liquidity in small-capitalization stocks?

A tick size pilot program to allow small issuers to choose larger trading increments would spur trading activity in emerging company stock. Under decimalization, market-makers have lost interest in spurring liquidity in small cap stocks. A pilot program to allow tick size flexibility for smaller issuers would provide incentives for market-making activity and thus increase trading. Allowing an increased tick size would grant flexibility to growing companies and increase the liquidity and capital availability necessary for emerging biotechs to be successful on the public market.

How would a tick size pilot program benefit investors?

The SEC adopted decimalization in an effort to increase trading activity for large issuers with millions of shares traded each day. Large companies enjoyed an influx of new investors, and issuer and investor alike benefited from increased liquidity and lower transaction costs.

However, at the same time, small issuers experienced a corresponding decrease in liquidity. Decimalization harmed both small companies and their investors. Allowing tick size flexibility through a pilot program will increase liquidity for small cap stocks – thus giving shareholders more trading options and increasing the likelihood that they will see a positive return on their investment.

What parameters are necessary for a tick size pilot program?

A pilot program could be targeted at companies that meet a certain revenue, public float, or trading volume test. A revenue test is an especially important marker for growing biotechs that do not have product revenue to fund their vital research.

Any pilot program should be in effect long enough for market participants to adapt to the new reality. A too-short pilot would not give investors enough time to change their habits and would thus not have the desired impact on small company liquidity.

Additionally, it is important that the increased tick size options in a pilot program apply to both trading and quoting increments.

Do you recommend that the SEC move forward with the tick size pilot program before the end of the year? In the absence of SEC action, would you support congressional legislation?

The JOBS Act has been enormously successful in spurring IPO activity in the biotech industry. Over 30 companies have gone public using the IPO On-Ramp, and many more are on file with the SEC. These newly-public companies could face liquidity and pricing issues detrimental to their public float and cash flow. It is important that the SEC or Congress take action to ensure a positive trading environment for emerging innovators. I support expeditious action, whether regulatory or legislative, to implement a tick size pilot program.

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