

**LEGISLATIVE PROPOSALS TO HELP  
FUEL CAPITAL AND GROWTH ON MAIN STREET**

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON CAPITAL MARKETS,  
SECURITIES, AND INVESTMENT  
OF THE  
COMMITTEE ON FINANCIAL SERVICES  
U.S. HOUSE OF REPRESENTATIVES  
ONE HUNDRED FIFTEENTH CONGRESS  
SECOND SESSION

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## **LEGISLATIVE PROPOSALS TO HELP FUEL CAPITAL AND GROWTH ON MAIN STREET**

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**Wednesday, May 23, 2018**

**U.S. HOUSE OF REPRESENTATIVES,  
SUBCOMMITTEE ON CAPITAL MARKETS,  
SECURITIES, AND INVESTMENT,  
COMMITTEE ON FINANCIAL SERVICES,  
*Washington, D.C.***

The subcommittee met, pursuant to notice, at 10:03 a.m., in room 2128, Rayburn House Office Building, Hon. Bill Huizenga [chairman of the subcommittee] presiding.

Present: Representatives Huizenga, Hultgren, Wagner, Poliquin, Hill, Emmer, Mooney, MacArthur, Davidson, Budd, Hollingsworth, Maloney, Sherman, Scott, Himes, Ellison, Foster, Sinema, Vargas, Gottheimer, and Gonzalez.

Also present: Representative Hensarling.

Chairman HUIZENGA. The committee will come to order. The Chair is authorized to declare a recess of the committee at any time. This hearing is entitled, "Legislative Proposals to Help Fuel Capital and Growth on Main Street." And I now recognize myself for 4 minutes to give an opening statement.

We all know that small businesses are what drive the American economy. These innovators, entrepreneurs, and risk-takers are critical to our country's economic prosperity. Small businesses helped create more than 60 percent of the Nation's new jobs over the past 2 decades. So if our Nation is going to have an opportunity that provides opportunities for every American, then we must promote and encourage the success and growth of our small businesses and startups.

In order to succeed, these companies need capital and credit, the lifeblood for growth, expansion, and job creation, yet the Government continues to construct arbitrary walls that cut them off from central financing, the smaller companies are caught up in red tape created for the largest public companies that have the financial means to hire lawyers, accountants, managers, and consultants to guide them through the sheer size, volume, and complexity of the Federal securities laws.

Since becoming Chairman of this subcommittee, one of my biggest concerns is the declining number of public companies, which has led to fewer investment opportunities for Main Street investors. IPOs, or initial public offerings, have historically been one of the most meaningful steps in the lifestyle of a—lifecycle of a com-

pany. Going public not only affords companies many benefits, including access to capital markets, but IPOs are also important to the investing public.

However, over the past 2 decades, our Nation has experienced a 37 percent decline in the number of U.S. listed companies. Equally troubling in my eyes, we have seen the number of public companies fall to around 5,700. These statistics are concerning because they are similar to the data that we saw in the 1980's when our economy was less than half of its current size.

These statistics demonstrate that regulatory costs associated with going public is deterring new and emerging companies from making the decision to go public, thus preventing our capital markets from reaching their full potential.

However, Congress has made strides in tailoring the regulatory environment for smaller companies, most notably when we passed, with strong bipartisan support, the Jumpstart Our Business Startups, or JOBS Act, in 2012. Signed into law on April 5 of 2012, the JOBS Act, which consisted of six bills that originated here in the House Financial Services Committee, was designed to help small companies gain access to capital markets by lifting burdensome securities regulation. By helping small companies obtain funding, the JOBS Act has facilitated economic growth and job creation.

Even President Obama called the law a game changer for entrepreneurs and capital formation. To further quote the words of former President Obama, the first JOBS Act was, quote, one useful and important step along the journey of removing barriers that were preventing aspiring entrepreneurs from getting funding. I completely agree.

Unfortunately, we need capital—much needed capital is unnecessarily left be—left on the sidelines right now. These small businesses make up 99 percent of all enterprises in America and employ about half of the American workforce, but they are being left behind as our economy continues to recover. The big are getting bigger, the small are getting smaller, and fewer small businesses are actually forming in the first place.

Regulatory tape is preventing small businesses from realizing their full potential. While small and middle market business optimism hover around record levels, burdensome red tape still is their ability—hampers their ability to obtain important capital to grow and thrive. Small businesses depend on access to financing to get off the ground, sustain operations, manage cash, make payroll, and create jobs, the very financing that all too often doesn't come through.

Implementation of the JOBS Act has demonstrated that while today's capital formation framework is better than it was 6 years ago, those 6 years have made clear that the JOBS Act was not just some magic formula. Aspects of the JOBS act, as well as JOBS 2.0, can and should be improved and other reforms should be implemented to further unleash innovation.

Our hearing today will examine several legislative proposals that will help fuel capital and economic growth on Main Street. Many of those proposals were outlined in the Expanding the On-Ramp report that was released last month by the U.S. Chamber of Com-

merce for capital markets competitiveness, BIO (Biotechnology Innovation Organization), SIFMA (Securities Industry and Financial Markets Association), Nasdaq, National Venture Capital Association, American Securities Association, dealer—Equity Dealers of America, and TechNet.

It is time for Congress to advance a broader capital formation agenda. Let us continue to build upon the success of the bipartisan JOBS Act by further modernizing our Nation's securities regulatory structure to ensure a free flow of capital, job creation, and economic growth. It is time to get the Federal Government working to support innovation, reward hard-working Americans, and lay the groundwork for tomorrow's economy.

And with that, the Chair now recognizes the Ranking Member of the subcommittee, the gentlelady from New York, Mrs. Maloney, for 5 minutes.

Mrs. MALONEY. I thank the Chairman for calling this important meeting, and welcome to all of our panelists. This hearing will consider 11 different bills designed to increase capital formation. Some of these bills have been considered by this committee before, while others are new proposals that we are seeing for the first time.

One bill in particular, H.R. 5054, which is the XBRL bill, is something I have expressed strong opposition to, and I continue to believe this proposal will harm, not help, capital formation, especially for small companies. Structured data like XBRL has enormous potential to improve our financial markets. It is the wave of the future, to make them more efficient, more transparent, and more accessible to ordinary investors.

Structured data puts all public companies, large and small, on a level playing field by making it easy for investors and analysts to quickly download standardized financial statements for an entire industry, and immediately start making cross-company comparisons to identify the best performers. This will enable investors to more easily identify those small companies with innovative business models that are true diamonds in the rough.

Ultimately, this makes our markets more efficient and our economy more productive, and helps small businesses. So I am still very concerned about a proposal that would completely exempt over 50 percent of all public companies from the requirement to file their financial statements using the efficient XBRL model.

Another bill, H.R. 5756, would make it more difficult for shareholders to influence the management of the companies that they own. Currently, the shareholders can re-file a proposal, which will get voted on at the company's annual meeting. If it received at least 3 percent of the vote the first time it was submitted, 6 percent the second time, 10 percent the third, H.R. 5756 would make it more difficult for shareholders to re-file proposals by raising this threshold to 6, 15, and 30 percent.

Oftentimes these proposals that the shareholders put forward help the companies grow, they are innovative ideas. According to a letter from the Council of Institutional Investors, and I quote, "It often takes several years for a proposal regarding an emerging issue to gain enough traction with investors to achieve double-digit votes," end quote. But they go on to note that, "In many cases,

these proposals eventually receive substantial support, leading to widespread adoption by companies,” end quote.

So cutting off these shareholder proposals on emerging issues could prevent positive long-term changes from being adopted.

Finally, H.R. 5877, introduced by Mr. Emmer, would allow for a new type of exchange specifically for small companies, a so-called venture exchange. I am certainly not opposed to the concept of a venture exchange, but I—I think it is important to get the details right. In particular, the bill would exempt any stocks traded on a venture exchange from State securities laws, which has historically only been allowed for larger, more mature companies that trade on full national securities exchanges.

I will be interested to hear from our witnesses on whether this State preemption is truly necessary for venture exchanges to be successful, or if there are alternatives that could achieve the same goal without State preemption, which is always contentious.

As I noted earlier, many of these are new proposals that this subcommittee has not considered before, so I am very eager to hear the testimony today.

And before I yield back, I would like to place in the record several letters that industry representatives have asked me to put in the record, one from the Council of Institutional Investors, one from Morningstar, one from OTC Markets, and XBRL US. I ask unanimous consent.

Chairman HUIZENGA. Without objection.

Mrs. MALONEY. And I thank very much the Chairman. I look forward to the testimony, and I yield back. Thank you.

Chairman HUIZENGA. The gentlelady yields back. We too are looking forward to this testimony.

With that, I would like to recognize the gentleman from Illinois, the Vice Chairman of this subcommittee, Mr. Hultgren, for 5 minutes.

Mr. HULTGREN. Thank you. Thank you, Chairman Huizenga, for convening this hearing. Access to capital markets in job creation is incredibly important in my district, and this subcommittee has the key responsibility of making sure the U.S. capital markets remain competitive.

I believe that it is extremely important for us to continue this work. I would also like to thank our witnesses for their work on the recent report Expanding the On-Ramp recommendations to help more companies go and stay public. The experts we have before us today will be important partners as we craft more legislation in the spirit of the JOBS Act.

I know the JOBS Act has made a meaningful impact in Illinois, and I am eager to hear how Congress can do more to spur capital formation. The Encouraging Employee Ownership Act, which I sponsored with John Delaney here in the House, will soon be on its way to the President’s desk for a signature, and I am hopeful to work on new legislation to help with job growth in Illinois.

And as has already been stated, and I know will be stated multiple times, we can’t lose sight of the fact that the number of public companies today is about half what it was 20 years ago. We went from about 8,000 public companies in 1996 to some 4,400 public

companies today. We need to learn more why this is, and how Congress can help change the trajectory.

Thank you, and I yield back.

Chairman HUIZENGA. Gentleman yields back. Today we welcome the testimony of a large panel, but we think—we wanted to get a cross-section on a number of things to—and issues to—to deal with today.

First and foremost, we have Mr. Brett Paschke, the Managing Director and head of capital markets for William Blair, on behalf of the Securities Industry and Financial Markets Association, or SIFMA.

Next we have Mr. Edward Knight, Executive Vice President and General Counsel for Nasdaq OMX.

Next we have Mr. John C. Coffee, Jr., who is the Adolf A. Berle Professor of Law at Columbia Law University—or, Law School.

Next we have Mr. Barry Hahn, Chief Financial Officer of GlycoMimetics, Inc., on behalf of the Biotechnology Innovation Organization, or BIO, organization.

Next, we have Mr. Barry Eggers, a Founding Partner of Lightspeed Venture Partners on behalf of the National Venture Capital Association.

Tyler Gellasch is next, who is the Executive Director of the Healthy Markets Association.

And last but not least, Mr. Tom Quaadman who is the Vice President of the Center for Capital Markets Competitiveness for the U.S. Chamber of Commerce.

Each of you will be recognized for 5 minutes to give an oral presentation of your testimony. Simple math says we have 35 minutes of testimony in front of us here, so feel free, if you have the ability to shorten that up, so we can get to questions, that is—that is fine, but it is your 5 minutes.

And with that, Mr. Paschke, you are recognized for 5 minutes.

#### STATEMENT OF BRETT PASCHKE

Mr. PASCHKE. Thank you. Chairman Huizenga, Ranking Member Maloney, and members of the subcommittee, thank you for the opportunity to testify today on the importance of preserving the vibrancy of our public capital markets. My name is Brett Paschke, and I am the Head of Equity Capital Markets at William Blair testifying today on behalf of SIFMA.

I joined this industry because I wanted to help business founders raise capital to build companies, invent products, solve problems, cure diseases, create jobs, and provide wealth creation opportunities for the investing public. All these years and many deals later, I am still motivated and inspired by the opportunity to help our clients achieve their missions.

On the Capital Markets side of William Blair's business, for which I am responsible, we are best known for serving the needs of small and mid-cap growth companies, including many innovative leaders in technology, health care, and life sciences. Over the last 10 years, we have been an underwriter on approximately 20 percent of all U.S.-listed IPOs. I will do my best to bring these perspectives and experiences to the subcommittee today, as I did in

serving on the task force that put together the recommendations that ultimately created the JOBS Act.

I still believe, as I believed then, that no single policy change will reverse the decline in public listed companies or unlock the IPO market. The authors of the JOBS Act understood this, and wisely took a holistic approach to improving capital formation. Policy-makers today should take on our present challenges with a similar mindset.

It is difficult to overstate the changes that have occurred in U.S. public capital markets over the last 20 years. An explosion in private funding, the rise of index and passive investing, electronic trading, hedge funds, consolidation, and regulation have all played a role in reshaping our markets.

Unfortunately, not all of these changes have been positive. As has been noted often, the number of publicly listed companies in the U.S. has fallen by almost 50 percent since 1996. The explosion of private capital markets has allowed companies to grow their businesses and valuations without ever tapping public markets.

It is worth discussing why this evolution matters. One important implication is that many startup companies are being built to be sold as opposed to being built to be independent public companies. This often does not lead to the same level of expansion and job growth with a long life as an independent public company does.

Another important implication is that access to the private markets is limited to a much smaller group of high net worth individuals and institutions, effectively excluding retail investors from the value creation that occurs within these opportunities. Our public markets provide much greater access to wealth creation, from direct retail investing to the mutual funds that manage money on behalf of individuals, retirement plans, pension funds, and endowments. Indeed, the need to support our public capital markets is why SIFMA and a broad coalition of stakeholders joined together recently to produce a report on these topics.

We also support many of the draft bills that have been released alongside this hearing, and, in particular, the draft legislation which would extend the EGC (emerging growth company) on-ramp from 5 to 10 years.

The JOBS Act's on-ramp of tailored financial reporting requirements and auditing and accounting standards greatly ease the burden for smaller companies going public. Providing a longer runway for companies to scale up to the full reporting requirements should incentivize more issuers to go and stay public. We also have the benefit now of having seen companies operate under these rules and investors react to them for 5 years, which can inform that extension.

Another critical topic to explore is the provisioning of research on publicly traded companies, which I believe is one of the most important and least understood facets of our public capital markets. At William Blair, we provide sell side research for over 600 public companies, with a focus on small and mid-cap stocks.

SEC (U.S. Securities and Exchange Commission) Rule 139 provides a safe harbor for research produced by broker-dealers participating in distribution if the issuer is a large reporting company

under the '34 Act. We feel that this safe harbor should be extended to smaller issuers as well.

In conclusion, I would flag that policymakers certainly have a challenge before them, in improving the vibrancy of our public capital markets and balancing investor protections. But the U.S. capital markets are the envy of the world and worth the effort to preserve. SIFMA and its members stand ready to assist the committee and the SEC in this important endeavor, and I look forward to your questions.

[The prepared statement of Mr. Paschke can be found on page 102 of the Appendix.]

Chairman HUIZENGA. Thank you very much for your testimony. With that, Mr. Knight, welcome back and you are recognized for 5 minutes. And if you can make sure that microphone is on and close to you. Thanks.

#### **STATEMENT OF EDWARD KNIGHT**

Mr. KNIGHT. Yes. Thank you, Mr. Chairman and Ranking Member Maloney. I am Ed Knight, I am the Chief Legal and Policy Officer at Nasdaq. And the question before you today is: How can we ensure the continued success of the U.S. public company model? When we think about that at Nasdaq, we go back to the beginning of our history in 1971, where we were the first in the world to have an all-electronic market with enhanced transparency through technology to protect investors.

Many thought we would fail. Many were against it, but the laws in the United States and regulations were flexible enough to allow it. We did succeed, and today we have 2,977 highly innovative entrepreneurial companies creating jobs and growing the economy every day. Among those companies are the five largest operating companies on the globe.

But at the core of our DNA is working every day to make a market for early stage companies, high-growth companies that will be the future Amazons, Googles, and Microsofts.

A little over a year ago, we looked at the question of the vibrancy of our markets and found that they were not very attractive to entrepreneurs, and very importantly, they did not meet the needs of individual investors who were often locked out of investing in these early stage, high-growth companies.

We looked at what were the possible solutions, we consulted experts from around the country, and we put together a number of proposals that we are proud to say are embedded in some of the legislation before you today.

This legislation does not represent radical change. We are not suggesting that you defund the SEC. We like the SEC, we want you to fund the SEC. We are not suggesting that we depart from the materiality disclosure standard that is embedded in U.S. law. These are largely technical changes. Some of these changes have been proposed by the SEC or adopted by the SEC through regulation. Some of them are extensions of the JOBS Act.

And frankly, we do not believe these are partisan issues. The JOBS Act was signed in a Rose Garden ceremony by President Obama. I served 7 years in the Clinton Administration Treasury

Department. Such considerations are not relevant to this debate, in my view.

The changes that are being proposed are part of the natural process of updating rules based upon experience with regulation. We work with these rules every day. They directly regulate our economy. In some cases, we have worked with them for decades. We know what works and what doesn't. The economy evolves rapidly and our regulations should also evolve with it.

If these changes are merely technical, why do we care? Why do you have this coalition that supports it so strongly? Is there some hidden agenda here? I would submit that by moving forward with these ideas, all that Congress is doing is signaling a willingness to work alongside entrepreneurs to make the markets stronger while preserving investor protection. This builds business confidence, which is the cheapest form of economic stimulus.

I want to just highlight a couple of elements of the bills with—before you. The venture exchange legislation addresses an issue that everyone recognizes that works with the markets, and that is they are designed to help large companies trade their securities. They are not designed to help small companies do it.

The market structure that applies today fragments liquidity across 50 or more venues. The venture legislation would allow a company, not a stock exchange, not a broker-dealer, but the company to elect to have all that liquidity trade at one place so we would have deeper liquidity and these markets would work better for smaller companies.

The 10-Q optionality bill, I would submit, would enhance disclosure by putting before investors an enhanced financial disclosure. At this moment, we have a two-part disclosure regime in which companies file an 8-K with their financial results, and a few weeks later a 10-Q that no one reads.

Give them the option, as under the venture legislation—the company the option to consolidate the material changes since their last quarter along with their financial disclosures, instead of making them file a 10-Q—which most people do not read—what moves the market is the 8-K, not the 10-Q.

The selling disclosure legislation would also enhance disclosure. We have disclosure about long holdings, but not short holdings.

Much of the other legislation, as I said, is—are extensions of ideas that the SEC has proposed in the Obama Administration that have been part of regulations that had been adopted by the SEC and would codify those.

We think they are modest.

Chairman HUIZENGA. Sorry—sorry, Mr. Knight, your—  
Mr. KNIGHT. Thank you.

[The prepared statement of Mr. Knight can be found on page 94 of the Appendix.]

Chairman HUIZENGA. Your time has expired. I am going to try and keep a tight rein on that for this. And with that, Mr. Coffee you are—you are afforded 5 minutes.

#### STATEMENT OF JOHN COFFEE

Mr. COFFEE. OK. Thank you Mr. Chairman, Ranking Member Maloney, and fellow members of the committee.

We have essentially been asked to comment on 11 proposals. On overview, I think these proposals range the gamut from promising ideas and useful studies that should be conducted to ideas that are irredeemably bad and would degrade our disclosure system.

But all of these 11 ideas come from one common source: This Expanding the On-Ramps study. And it in turn, in connection with the JOBS Act, is based on the same idea that moved the JOBS Act. That somehow the SEC discourages IPOs because of overregulation and very costly rules.

I think the vast majority of professors who study this area, of law professors and finance professors, think that is very overstated and borders on a myth. It is a myth that gets perpetually—continually asserted, and I think we should understand what reality looks like.

The world changed dramatically in 2001, when the high hot issue bubble crashed. We have never approached that level of IPOs since. It was like the falling off of a cliff. And what caused this? Well, we should remember that underregulation can be even more dangerous than overregulation. Underregulation caused investors to flee the new issue market, and we have never gotten many of them back.

The JOBS Act didn't really cure this problem at all. IPO volume continued to fall, and in 2015 and 2016 it was lower than in years before the JOBS Act. Although there has been some comeback this year in high-tech offerings, the smaller offering continues to approach extinction. Small offerings are both few and generally unprofitable.

Now, if all this were caused by high regulatory costs and SEC overregulation, then the decline in IPOs would be a uniquely American problem caused by American overregulation. But it is not an American problem. It is a worldwide problem. IPO volume has declined even more dramatically in Canada, and the decline in Europe and Japan is as great as the decline in the U.S. of IPOs by number of offerings.

And because Canada has no national securities regulator, there was no overregulating national adviser. There are 11 different provinces and IPOs are virtually extinct in Canada currently.

Something else is causing the problem. What else is there? I will give you two principal causes, although there are others. They would be, first, private companies find it easier, quicker, and cheaper to raise capital in robust private markets where litigation risk is much, much lower, private firms can raise capital in these markets in weeks, not months, and with much less diversion of executive time. That is reason one.

Two, IPOs for smaller firms have been consistently unsuccessful for a sustained period. Jay Ritter, a prominent finance economist, in his latest study finds that about 80 to 90 percent of these small offerings are characterized by negative earnings-per-share in subsequent years.

In short, small issuers remain unprofitable, and as a result analysts and underwriters are coming to shun these deals. Academic research suggests that the relative disappearance of small IPOs is probably because these smaller issuers cannot gain the economies

of scale and scope that are increasingly necessary to compete in a globalizing market.

Is there a crisis? I suggest not. A company can get capital easily in the venture capital market, and the smaller firms, although I wish they could find a way to do an IPO, can get successful exit strategies through the merger market. Frankly, the smaller firm gets a much higher price in the merger market than in the IPO market, and thus it will go in that direction.

Given these problems, I don't think we should relax disclosure and Government standards to encourage more small IPOs that are already losing money.

In my last half minute, let me give you my nominations for the best and worst ideas among these 11. I think one truly promising idea is venture exchanges, but it has a very flawed execution here. The way this bill is drafted, it looks like a fly by-night group could set up its own venture exchange tomorrow, and the SEC would be in the position of an overworked fireman racing from fire to fire to put out the various crises.

And if you think that is not possible, you should look at what is going on in the cryptocurrencies exchanges, where we see some very disreputable people working behind exchanges. The idea that I think is most problematic—and I will stop here—is the idea of substituting a press release for the form 10-Q. That would really end our disclosure system as we know it today.

Thank you.

[The prepared statement of Mr. Coffee can be found on page 42 of the Appendix.]

Chairman HUIZENGA. Thank you, the gentleman's time has expired. And with that, I owe Mr. Brian Hahn an apology. I was going to my list, and Barry Eggers and Brian Hahn sitting next to each other. So with that, Mr. Brian Hahn, you have 5 minutes.

#### STATEMENT OF BRIAN HAHN

Mr. HAHN. Good morning, Chairman Huizenga, Ranking Member Maloney, and members of the Capital Markets, Securities, and Investments Subcommittee.

My name is Brian Hahn, and I am the Chief Financial Officer of GlycoMimetics, a 48-employee public company based in Rockville, Maryland. I am happy to be here today to discuss proposals to help fuel capital and growth, and how they will help GlycoMimetics and other early stage biotechnology companies in our pursuit to fund the next generation of treatments.

The ability of growing business to access the public markets is of paramount importance to biotechnology innovation, because investment capital is the lifeblood of scientific advancement. It can cost over a billion dollars to develop a single treatment, and most companies spend more than a decade in the lab before their first therapy is approved.

During this long development process, virtually every dollar spent by an emerging biotech company comes directly from investors. To that end, the JOBS Act has been an unqualified success, enhancing capital formation and allowing 260 biotechnology companies to focus on science. It certainly helped pave the way for GlycoMimetics' IPO in January 2014, and has helped us nearly

double our employee headcount and move three new drug candidates into human clinical trials.

Given the long development timelines and substantial costs, legislation being considered today that would extend the JOBS Act on-ramp and provide other relief for emerging innovators would be extremely beneficial for growing companies like mine. When GlycoMimetics rolls off its EGC status in a few short months, we will lose the key JOBS Act exemption and will be subject to the erroneous and expensive disclosure burdens as mandated by Sarbanes-Oxley Section 404(b).

While a private company, our audit fees were just \$40,000 a year. After our IPO, our audit fees increased by roughly \$500,000 due to the existing regulatory environment from public companies. Absent additional exemption, we expect our SOX 404(b) compliance obligations to alone more than double our cost to as much as \$1.2 million annually starting in January 2019, when our 5-year exemption ends.

I would like to thank Representatives Kyrsten Sinema and Trey Hollingsworth in this subcommittee for their efforts in drafting H.R. 1645, the Fostering Innovation Act. This bill recognizes that a company that maintains the characteristics of an EGC is very much still an emerging company, even if it has been public for longer than 5 years. I am hopeful that the Senate will also recognize the importance of the Fostering Innovation act in a timely manner before any more companies are rolled off the JOBS Act provision and subject to the rules of—burdens.

In addition, draft legislation being considered by the committee today that expands the SEC's definition of non-accelerated filer would also help small business innovators avoid the burdens of Section 404(b). Under current SEC rules, companies qualify both as an SRC and a non-accelerated filer if their public float falls below 75 million. SRCs benefit from scaled obligation under regulation SK and regulation SX, while non-accelerated filers are exempt from Section 404(b). Increasing the public float cap and adding an annual revenue test would be tremendous benefit to small business innovators.

Another issue of concern for small public companies is proxy advisory firms. I want to thank Congressmen Sean Duffy and Gregory Meeks for their bill, H.R. 4015, the Corporate Governance Reform and Transparency Act, which passed the House last December on a bipartisan basis.

The role of proxy advisory firms has grown to have an outsized influence in the decisionmaking processes of emerging biotechs and their shareholders. When a proxy firm issues a recommendation that is not applicable to an emerging biotech and remains unwilling to consider alternative approaches or methodologies, it can harm a company's relationship with its shareholders, and distract management from the core business of the company.

I would also like to thank Representative Duffy for H.R. 5756, which would adjust certain resubmission thresholds for redundant shareholder proposals that burden many small biotechs.

I would like to take a moment to discuss the problem of manipulative short-selling and express my support for a disclosure regime for short sellers. The unique business model for groundbreaking in-

novation leaves emerging biotechs particularly vulnerable to stock manipulation.

BIO acknowledges that appropriate shorting can support the stable, liquid markets that fuel the growth of emerging biotech innovators, however, we strongly believe that current lack of transparency related to short positions is enabling trading behaviors that unfairly harm growing companies, long-term investors, and most importantly, patients.

Finally, I would like to mention XBRL compliance, an issue that seems technical but can have significant costs for small companies like mine. The Extensible Business Reporting Language is an attempt to make it easier for investors to compare financial data, but with—as with many of the issues I have discussed today, it disproportionately affects small issuers due to its one-size-fits-all approach.

Cost of compliance can be significant. GlycoMimetics is forced to spend \$50,000 to \$60,000 every year on XBRL and without much benefit to investors. Biotech investors are less concerned with the reporting metrics that XBRL compares and more concerned with the actual science of the company and their path forward toward FDA (Food and Drug Administration) approval, and ultimately getting the drug to the market.

BIO appreciates, therefore, Congressman David Kustoff's legislation, H.R. 5054, the Small Company Disclosure Simplification Act that exempts EGCs from XBRL reporting requirements and provides temporary XBRL exemptions for companies with revenues below \$250 million.

I would like to thank the subcommittee for considering further initiatives for small business innovators, and I look forward to answering any questions that you may have.

[The prepared statement of Mr. Hahn can be found on page 88 of the Appendix.]

Chairman HUIZENGA. Thank you for that. Mr. Eggers, you have 5 minutes.

#### STATEMENT OF BARRY EGGERS

Mr. EGGERS. Chairman Huizenga and Ranking Member Maloney, thank you for the opportunity to testify here today on the important subject of capital markets reform and encouraging more U.S. public companies.

My name is Barry Eggers, and I am a founding Partner at Lightspeed Venture Partners, a venture capital firm that invests in and works closely with cutting-edge technology startups. We invest in areas such as information technology, big data, cloud computing, networking, eCommerce, and consumer marketplaces. I am here in my capacity as a board member of the National Venture Capital Association.

Let me begin by explaining why venture capitalists care about policy issues pertaining to our public capital markets. There are three main ways that venture capitalists exit an investment. Number one, a merger or acquisition; number two, an initial public offering, or IPO; or number three, a business failure.

While the vast majority of venture capital investments are in private emerging growth companies, or EGCs, recent research has

shown that nearly half of all companies that have gone public since 1979 have been backed by venture capital. In other words, VCs build the product for the IPO pipeline.

To provide a little background on venture capital, we are investors in the Nation's startups. At Lightspeed, for instance, we invest early in a company's life, often when there are a few founders trying to build out a new concept.

We work with these entrepreneurs to grow the company into a successful enterprise, including providing mentorship and strategic advice, helping them hire new employees, introducing them to potential customers, and providing additional rounds of financing to fuel continued growth. This work typically takes a lot of patience over a long time horizon. At Lightspeed, the average time to IPO from first investment is roughly 8 years.

I have been a venture capitalist for over 2 decades, and in the technology ecosystem for over 30 years. When I first got started in the business, the goal of most entrepreneurs was an IPO, and many companies were successful in that endeavor, such as Maker Communications, a company I invested in that went public in 1999. Maker had quarterly revenue of \$3 million prior to their IPO, and went public at a valuation of \$230 million.

Twenty years later, many entrepreneurs now view the public markets as hostile to small-cap companies and would rather have the certainty of a trade sale than deal with the challenges, complexities, and costs of running a public company.

And for those that do go public, they often do so when they have grown to a size that can better bear the burdens that come with being public, such as Nimble Storage, another company I invested in which went public in December 2013, and is representative of the first batch of EGCs to go public under the 2012 JOBS Act. Nimble had quarterly revenue of \$33 million prior to their IPO, which valued them at \$1.5 billion; over 10 times larger in revenue and six times more valuable than Maker.

My firm, Lightspeed, has one of the strongest track records of IPOs since 2016. We have had seven portfolio companies go public over the last 2-1/2 years. That is still less than 5 percent of the 145 active companies in our portfolio.

Avoiding the public markets has unfortunately become the prevalent view among many EGC executives. The issues that discourage EGCs from going public can be grouped into three broad categories. Number one, the increased cost and complexity of running a company; number two, the collapse of market-making infrastructure, including research coverage; and number three, the challenges presented by a culture of short-termism.

In each category, since the turn of the millennium, policy changes and industry trends have conspired to increase the headwinds facing small public companies. I believe there are two significant consequences arising from the lack of IPOs and the decline in U.S. public companies; less job creation, and loss of investment opportunities for retail investors.

Research indicates that the lack of IPOs has cost the economy on average about 2 million new jobs a year. From what I have seen, many of these jobs can be the type that support middle-class families and don't necessarily require college degrees. Thinking, for in-

stance, about human resources or administration jobs, which often disappear after a merger.

A lack of IPOs has also had an impact on middle-class retirement savings and retail investment portfolios. Think about Amazon, Genentech, Microsoft, or Intel as examples of companies that created exponentially more wealth in the public markets than private markets.

The joint report endorsed by NVCA, Expanding the On-Ramp, offers a blueprint for building off the success of the JOBS Act and making it more attractive to be a public company. The report considers a breadth of perspectives from company operators, people whose job it is to facilitate public offerings, exchanges, and investors.

While I note several policy proposals in my written testimony, I did want to take time to reference one now. I strongly support the proposal to allow any investment in an EGC to be qualifying for purposes of the VC exemption definition from the RIA regulatory regime.

Congress created both the EGC definition and the VC exemption for similar purposes; namely, a favorable capital formation regulatory environment for growing companies. That secondary share purchases of EGCs are currently nonqualifying is becoming an increasing challenge for VC funds that are forced to choose between supporting their company's growth while risking the significant expense and difficulty of registration, or passing on further capital formation opportunities for certain portfolio companies. Happy to answer any questions.

[The prepared statement of Mr. Eggers can be found on page 63 of the Appendix.]

Chairman HUIZENGA. Thank you, Mr. Eggers. Mr. Gellasch, you have 5 minutes.

#### STATEMENT OF TYLER GELLASCH

Mr. GELLASCH. Thank you. Chairman Huizenga, Ranking Member Maloney, and members of the subcommittee. Thank you for holding the hearing today and for offering us the opportunity to appear.

I am the Executive Director of Healthy Markets Association, and our members are the pension funds and investment advisors that folks here seem to be concerned with in the public markets.

And today, we are here to discuss at least 11 legislative proposals, so just let me cut to the chase: Not one of these proposals is likely to measurably increase the investment in public capital markets or improve the economy for Main Street, and several of the proposals are likely to have the opposite effect.

The reason is simple. They either ignore or affirmatively harm investors in the public markets. From the vantage point of an investor in the public markets, these proposals reduce the quantity, quality, or utility of information available to them.

They increase the riskiness of a company's financials, such as by removing required audits of internal controls. They increase the valuation risks of the company. They increase the costs of trading those securities. They divert investment opportunities from the public markets by further easing limits on private securities such

as through the ventures exchange. And they decrease corporate accountability to shareholders by restricting shareholder proposals, by reducing access to proxy advisors, or other reforms.

The proposals aren't offering any reason for investors to want to put more money into the public capital markets, and so I will argue that they will likely have the effect. I appreciate the Chairman's focus, and many of the folks here, on the public markets, but of course they matter. Public securities are often accompanied by more robust accounting and financial business disclosure practices, and that is a given.

But they are also—information about public companies, including third-party research, is more readily available and fairly distributed. Public securities are far more easily and reliably valued, and really importantly from an investor's perspective, liquidity is significantly greater. Trading costs are significantly lower.

If we are talking about fractions of a penny a share, or a penny a share, or maybe a few pennies a share in the public markets, we are talking orders of magnitude greater cost for investors in the private markets.

And frankly, that is a transaction cost. That is lost returns for investors. Public securities are much more easily benchmarked, such as against the S&P 500. These factors play an important role for pension funds and investment advisors who are fiduciaries to their beneficiaries to minimize costs and minimize risks.

Unfortunately for them, as many have noted here, the public markets have dwindled. The vast majority of the decrease in public companies, 2,800 of the lost companies, were lost before 2003. That is well before Sarbanes-Oxley, and well before the Dodd-Frank Act and its CEO pay ratio disclosures, and it was after proposals and—that were implemented in the 1990's to curtail private litigation.

So if those things didn't cause the decline, what did? Well a lot of things, but most importantly, the SEC and Congress, frankly, at the urging of many of the folks I sit on the panel here with today, spent years digging trenches to drain capital and companies out of the public markets, usually in the name of promoting access to capital for small companies.

So put simply, many companies don't go public anymore because they can do things like raising money. We talked about the explosion of private capital; that is it. We made it so that you can do a private offering with a Super Bowl halftime commercial. You can do it over an internet radio ad. That was never allowed before.

Policymakers' and regulators' obsession with IPOs is also somewhat misplaced. Do we really think it is a good idea to return to the 1990's, when a sock puppet can raise millions of dollars in an IPO? Could it be that as—as Mr. Coffee alluded to, that perhaps public investors are concerned with IPOs because they have chronically underperformed the markets, and that a lot of the IPOs that do come to market these days are exits from folks like venture capital firms and—and executives?

Do we really think that undercutting the reliability of a company's financial reports or a company's accountability to shareholders is going to make investors more interested? We don't. So we offer three alternatives.

First, we share the concerns with many about the lack of good research into small cap companies, but rather than forcing investors to pay more for trading, as the failed Tick Pilot suggested, how about we let investors separately shop for research in a transparent market? To do that, we encourage you to direct the SEC to empower investors to be able to separately shop for the research they want and the trading services they need.

Second, we encourage you to reduce the exemptions and exceptions from the Federal securities laws. We should stop digging trenches out of the public capital markets. It is time to put down the shovels.

Third, we urge you to think about rules that promote industry consolidation. The difference between large and small cap companies in raising capital has a lot of reasons, and I—thank you—I—for the opportunity speak before you, and I look forward to questions.

[The prepared statement of Mr. Gellasch can be found on page 67 of the Appendix.]

Chairman HUIZENGA. I appreciate that, and Mr. Quaadman, you have 5 minutes.

#### **STATEMENT OF THOMAS QUAADMAN**

Mr. QUAADMAN. Thank you, Chairman Huizenga, Ranking Member Malone, and members of this subcommittee. We appreciate this subcommittee's continued focus on issues related to business creation and growth.

The atmosphere for business creation and the path for growth is not what it should be. Systems that have supported the ability of businesses to start and then grow from small to large have not kept pace with the times or international competition.

We have seen 10 years after the financial crisis continued depressed business creation rates, and we continue to be hundreds of thousands of businesses short from where we should be, historically. We have also seen a 20-year decline in the number of public companies and an anemic IPO market over the same period of time. Indeed, we have seen a calcification of entrepreneurship, where 50 percent of all business startups in the United States are concentrated in 20 counties.

Action is needed. There are several reasons for these problems and much needs to be done to address the situation, and indeed some things have already been done. The JOBS Act and the JOBS Act 2.0 measures in the Highway Bill have arrested the decline of public companies and we have seen a modest increase in IPOs in the 6 years since the JOBS Act passed.

S. 2155, which was passed by the House yesterday and should be signed soon by the President, helps to restore community and regional banks to being a Main Street business liquidity providers. However, it is important to remember that 75 percent of all business financing and development happens in the non-bank financial markets.

More needs to be done and we need to reverse this situation. That is why the Chamber and seven other trade associations, under the leadership of Brian O'Shea, last month issued a report on expanding the IPO on-ramp. That report includes 22 rec-

ommendations which are centered around JOBS Act enhancements, increased research, corporate governance and disclosure improvements, financial reporting issues, and equity market structure reforms.

These ideas, and many of the bills already passed by the House, can form a core of a JOBS Act 3.0. Indeed, the bills that we are discussing today are a good step forward. These bills will increase liquidity, extend JOBS Act protections, address the resubmission thresholds issue, reduce redundant disclosures, establish venture exchanges, and generally remove obstacles to growth.

Indeed, last month we also released a poll which shows widespread support for these measures. Indeed, over 90 percent of Americans agree that there needs to be a level playing field for IPOs, and also agree that the rules of regulators should promote growth and that all investors should benefit from them.

Additionally, over 75 percent of Americans believe that regulators should simplify the IPO process, and they also agree that Government policy should be geared for growth; that support cuts across all ideological, generational, and economic lines.

And we also can't wait because of international competition. The China 2025 and 2050 plans are specifically geared to make China, not the United States, the innovation center moving forward. Also the EU, with its capital markets union proposal—they are also looking to build out their non-bank financial system; in fact, copying many of the things we do here in the United States.

However, many of the Brexit-related proposals are also specifically designed to keep American financial firms out. Indeed, the EU also sees itself as a global regulator. Their MiFID (markets in financial instruments directive) specifically impacts research here in the United States, and in fact will make it more difficult for Congress to incentivize research for smaller IPOs.

Indeed, some things are also positive. The SEC, unlike in 2013, is a willing partner to work on these issues. But it is important to remember that it is Congress that sets the public policy parameters, and it is Congress that ultimately will lead us down the road that then the regulators can help fill in the blanks.

We look forward to working with this subcommittee on these issues, and thank you, happy to take any questions you may have.

[The prepared statement of Mr. Quaadman can be found on page 112 of the Appendix.]

Chairman HUIZENGA. Well, "A" on turning in 50 seconds. Thank you, Mr. Quaadman.

Now I—at this time, I will recognize myself for—for 5 minutes for some questioning, and clearly we heard some contradictory things here. Mr. Hahn, Mr. Eggers, you had both talked about—I think Mr. Eggers talked about an EGC that had gone public, Mr. Hahn, you were talking about some of the other biotech.

Professor Coffee had said that there really isn't a problem, and that the JOBS Act—I—I got it down here—didn't address the issue of IPOs and the lack of IPOs at all, and so I am curious. Is this worth pursuing?

We are—we are looking at a—we have done a non-legislative—but a package, but a JOBS 2.0 previously, we are working on a JOBS 3.0, for lack of a better working title at this point—but did

we have a problem and did the JOBS Act and these types of reforms actually address the problem?

Mr. Hahn, Mr. Eggers?

Mr. HAHN. I think the JOBS Act did—did help address these problems. What—I am sitting here today talking about—what I would like to see is the extension of the 5-year on-ramp, especially for us with 404(b).

We do a third-party audit of our internal control that gets reported directly to the audit committee. That costs us less than \$50,000 a year. To have—and I have a proposal, since next we are going to roll off of that from our audit firm, \$650,000 a year for our audit firm to audit those results. And the third party will go from \$50,000 up to \$150,000 a year.

And 98 percent of our balance sheet is still cash. We have no revenues yet, we still only cut 125 checks a month, we still only have two check signers. So for that additional \$650,000 to \$800,000 in added expense, it doesn't add any more safety to investors. We have good controls, we have been audited. So, from my standpoint it is the extension of the EGC until we are—we are producing revenue.

Chairman HUIZENGA. OK, Mr. Eggers? Can you make sure you hit your mic?

Mr. EGGERS. I do believe it has helped. I have seen it first-hand. I mentioned Nimble Storage, which was one of the first companies to go out under the JOBS Act in December 2013. They filed confidentially, they were able to work under EGC status.

One of the problems, though, is that an EGC status doesn't last very long, potentially because you can become a large accelerated filer very quickly at the \$700 million threshold. When these companies go public, they are very volatile. I looked at the last seven companies that we have taken public since 2016, and in the first 6 months of trading the difference between the high price and the low price was on average 68 percent. So many of those lost their EGC status.

Chairman HUIZENGA. OK. And I think it was Mr. Paschke who—you had talked a little bit about providing a longer runway? Is that correct? Is that relative to what Mr. Eggers was talking about?

Mr. PASCHKE. Yes, so there are two things I would say. First, why do investors care? One is IPOs have actually outperformed the S&P 500 in 2015, 2016, 2017, and 2018 year to date. So I did want to get it out there that IPOs in—are in fact working and a good vehicle for wealth creation.

Extending the on-ramp, to me—and as I mentioned in my opening statement, I was part of the initial set of recommenders on the task force—there is a timeframe on them to see how it worked. To see if the market reacted, if there was pushback from investors. If some of the disclosure allowances led to problems or information issues. As we sit here now, 5 years later, there really haven't been issues. Virtually every company that has been eligible has taken advantage of those allowances and there has been really no pushback or valuation differential afforded them by the market.

So it feels like the extension is appropriate for existing public companies who already became public, but also helps incentivize others to—

Chairman HUIZENGA. Real quickly because I think this is one of the things that Professor Coffee brought up. He basically said that there is enough money out there. We don't need the IPOs, venture—is there enough cash out there? What is the—what is the purpose for accessing it?

Mr. PASCHKE. I think that is actually one of the most important points. There is a lot of money out there, it is privately funded. It is being invested by high-net-worth individuals in venture capital firms, so all the value creation is accruing to very few people.

So in an era where income inequality and wealth equality is such a topic, I think we need to be encouraging greater access to that wealth creation and there is just no question that the public markets, through all its vehicles, is the number one way to do that.

Chairman HUIZENGA. Well, it is interesting you say that. I—literally, I will read verbatim what I had written down: How do common investors, non-high-net-worth investors access the upside of market growth? That in my mind is one of the major elements in this—in this entire thing. My time is up and I—and I am going to be a little generous here with the questioning since we have a few people up here. Because I real quickly—I would like Mr. Knight to address 5756.

Is there an issue or a problem? And what do you hear from those public companies who work with or are on the—on Nasdaq with some of those activist shareholders and some of their—some of their proposals?

Mr. KNIGHT. Well, yes. Shareholder activism is a major factor in the public markets. It is a reason why some entrepreneurs choose not to go public. Shareholders should be active. Shareholders should be engaged. But it is the short-term focus, often of activists, that distorts the market. And that is why we support legislation that would provide more transparency about shorting the market.

We think that would be healthy. And—but activism is a major factor in the market today and it—it is something many are concerned about.

Chairman HUIZENGA. So appropriate for it to be addressed?

Mr. KNIGHT. Yes. Yes, sir.

Chairman HUIZENGA. All right, my time is well-exposed—expired. With that, the Ranking Member. Or the—

Mrs. MALONEY. Thank you. I would like to welcome John Coffee back to the—to the panel. And I would like to ask you about the venture exchange bill which you called promising. As I mentioned in my opening statement, I am not opposed to this concept, but I have some concerns about preempting State securities laws. And is there a way to make the venture exchange model work without exempting State laws, or preempting State laws?

Mr. COFFEE. Right now, the alternative to a venture exchange is the alternative trader, ATS system, which has a number of companies trading over the market. Venture exchanges may prove to be a more interesting, more novel, more creative alternative. We don't know until we try. But we have seen that under regulation ATS, we have small companies trading in the over-the-counter market without a preemption of State blue sky.

So it is possible to have entrepreneurs trade over-the-counter small companies even though they are subject to State blue sky

regulation. And frankly, this is the key point about this, when you have a venture exchange, you are going to have a thin market. Thin markets invite pump and dump schemes. You need resources to monitor those pump and dump schemes, and the SEC tends to focus on bigger issues, bigger higher-profile cases. And we need the States which are very familiar with some of these smaller companies, and I think are better monitors for them.

That is the problem about preemption. The other problem I was pointing to was that the way this statute is written, the SEC has to shut you down. You can start trading as a venture exchange until the SEC comes in and says you must stop. I think that puts the SEC under undue pressure. They have to run like a fireman from fire to fire and I think you will get fly-by-night operators under that kind of structure.

But the idea I still think is promising.

Mrs. MALONEY. Would anyone else like to comment on it? Just—  
Mr. GELLASCH. Thank you—thank you, Congresswoman, I would.

I think that there is actually a reason why pension funds and investment advisors aren't beating down the door for more IPOs and pulling companies into public markets. And frankly, I think the venture exchange is likely to just make it easier for the existing investors and executives of those companies to exit. But it is not going to be the thing that pulls public pension funds or investment advisors or fiduciaries into those markets.

So it is not actually going to have that effect. It is not going to be able to overcome the costs or risks associated with those private securities.

Mrs. MALONEY. Anyone else?

Mr. KNIGHT. Yes—

Mr. QUAADMAN. Yes, Ms. Maloney. I am sorry, Ms. Maloney, we are supportive of it, and I think one thing to remember here is that the small investor's been shut out. The retail investor's been shut out. This is a platform where the SEC can put very robust rules in place for oversight, allow for concentration liquidity, allow for smaller investors to participate in this, and it is just another way and another venue of trying to drive liquidity to smaller public companies.

Mrs. MALONEY. Anybody else? Comments?

Mr. KNIGHT. Yes, I would just point out the SEC has 6 months to license these exchanges. They have been licensing new exchanges quite rapidly. We now have 13 of them in the United States, no other country has that many. With regard to Nasdaq and the venture legislation, we would be able to trade these securities because our listing standards are already blue sky-exempt by statute and regulation.

So this would encourage more competitors to Nasdaq which I don't think is a bad idea, we are not against competition. And—but I think there is a way to do it. Professor Coffee definitely has a point that State securities regulation plays an important role. But with regard to the New York Stock Exchange and Nasdaq, right now we are exempt.

Mrs. MALONEY. OK, I would like to also ask about the XBRL bill. And I would like to ask Mr. Gellasch here, your organization represents investors and I believe that it is the investors who benefit

the most from a structured data like XBRL. Do you think that exempting over 50 percent of public companies from the requirement to use XBRL will harm investors and ultimately transparency? And I would also like to ask Mr. Coffee and anyone else, Mr. Quaadman and others, to respond.

Mr. GELLASCH. Thank you for the question. I think I am struck by the dichotomy of two—of different proposals here. On the one hand, we are saying that we want to encourage research into small companies and the utility of that research into small companies. On the other hand, we are actually going to make that research less useful for the people who read it. XBRL is common and it is something that folks need to have to compare investment opportunities.

And so one of the things that is really interesting here is, we are saying on the one hand, we need to do things to promote research into small companies. And on the other hand, there is a proposal to expressly go in the opposite direction.

Mrs. MALONEY. Mr. Coffee?

Mr. COFFEE. Just one sentence. XBRL is a tool, a cost-saving tool. We want analysts to study the smaller company. They are not doing it now because the costs of benefits don't work out for them. If you reduce the cost, you might get more analyst attention to smaller companies. So, I think it will encourage analysts to look at smaller companies.

Mrs. MALONEY. Yes, Mr. Quaadman?

Mr. QUAADMAN. Yes, thank you Ms. Maloney for that question. First off, we support use of interactive data like this for investors. However, XBRL, from studies I have seen, only 11 percent of investors actually use it extensively. That is a CFA study. So, this would actually allow for companies to have the option to deal with this—to deal with the cost and the like.

But I think we also have to understand, too, XBRL is a 1998 platform, as we are increasingly going into a block chain world. So, if we can go into a block chain world where you have a common electronic ledger where everybody is connected with, that is much more transparent and easier to use in an XBRL system. So, I think we also need to be very open to other innovative ways of disseminating data.

Mrs. MALONEY. My time is expired. Thank you. I thank all of the panelists. It was very interesting, thank you.

Chairman HUIZENGA. With that, our Chair of the Oversight and Investigations Subcommittee, the gentlelady from Missouri, Mrs. Wagner, for 5 minutes.

Mrs. WAGNER. Thank you, Chairman Huizenga and I think my friend, the gentleman from Arkansas for yielding me the opportunity to move ahead of him.

Mr. Quaadman, welcome back. In your testimony, you noted a 2011 report of the IPO task force found that 92 percent of public company CEOs said that the administrative burden of public reporting was a significant challenge to completing an IPO and becoming a public company. How does my draft legislation on 10-Q reporting help to alleviate that burden?

Mr. QUAADMAN. Yes, so, first off, let us remember your bill doesn't hide any information. That information is already put out

there publicly. It allows companies to do it in a different way. So, I think if you take your bill, you take some of the legislation here, in terms of shelf registration—

Mrs. WAGNER. Right.

Mr. QUAADMAN. Other things such as company file, which we have proposed in the past. It allows for information to be put out there for investors without being done in a redundant fashion, and then avoiding those costs. So, this isn't hiding the ball for anybody.

Mrs. WAGNER. Thank you. Mr. Knight, your colleague, Tom Whitman, testified before this committee, last year. And noted, the Nasdaq believes it is long past time to move away from a one-size-fits-all approach to corporate disclosure.

In fact, Mr. Whitman suggested eliminating the archaic 10-Q form altogether because it was duplicative and bureaucratic. Can you quickly walk committee members through some of the duplicative standards that exist between the current Form 10-Q and company earning releases?

Mr. KNIGHT. Well, the—the premise behind this is, I would quote a famous technology pioneer, Grace Hopper, who was an Admiral in the Navy who said, "The most dangerous phrase in the English language is, we have always done it this way." And there is a redundancy to disclosure in our system today.

But it is undergirded by a principle of materiality, and we think what you have proposed would preserve that materiality, while also the key financial disclosures that are required under Reg S-K and that come out in an 8-K and which is what really moves the market. When you look at the Nasdaq market, on any day, where there are substantial movements is where someone has had an earnings release and put out their 8-K with their full financial disclosure.

Now, full—a few weeks later, they make a—a 10-Q filing. That filing has a number of things in it, some of it redundant to the K, but any material change since the last disclosure would be in that, we would combine that through your legislation in one disclosure.

It would be at the option of the company and I think that is important that several pieces of legislation before the subcommittee restore some role for the listed company in how it is regulated and give them some choice.

Mrs. WAGNER. What—what are the costs and resource burdens on companies that are required to file 10-Q forms with the SEC?

Mr. KNIGHT. Well, I—when you are talking about cost, there is a dollar cost, but then there is, what I referred to in my testimony and my statement, the signaling that goes on through regulation to the economy, to the business community, about the attitude of regulators in Congress toward what they are doing on a day to day basis.

When they see things that don't make sense—when they see redundancy and they think about going public and that—that is a very long-term commitment they are making. Do they want to be part of that system? When you signal that you are making the system and the technical aspects more rational, they get more confidence about jumping into that.

So, it is more than just the—the cost in dollar terms. It is rather, the system is being run in a rational way that reflects the fact that

these are the companies that are creating the jobs and the growth in this country.

Mrs. WAGNER. Are press releases sufficient for investors to obtain the information they need to make form-informed investment decisions?

Mr. KNIGHT. No, no. It needs to be prescribed, but the current system, I would argue, is redundant. And the Qs are really not studied in the same way the K is. So, why not use that disclosure to put everything in it, again, at the company's option.

Mrs. WAGNER. Great, thank you. I yield back the remainder of my time.

Chairman HUIZENGA. The gentlelady yields back. With that, the gentleman from Georgia, Mr. Scott, is recognized for 5 minutes.

Mr. SCOTT. Chairman, I am sitting here listening to all of you and you have such great knowledge and each of your testimonies has been very informative, but there is some cross-section going on here on one side or the other.

And it fits it with some of the concerns that I have. And I want to start by saying that—I want to emphasize that, both the Republicans and Democrats, on this committee are willing to work together to make it easier to fuel capital growth in our markets.

As a matter of fact, I am usually the first to jump onboard to proposals like that. However, listening to you and just my own research, I am beginning to get a little worried about—we are getting to a point where we may be placing too much value on capital growth.

And maybe we need more evidence and assurances that this actually needs to be done and that we are not compromising the integrity of many of our U.S. firms in our marketplace, which makes our U.S. firms so attractive. So, I am not singling out any bill here, but let me call your attention to the discussion draft that has to do with requiring the SEC to revise the definition of a qualifying portfolio company to include emerging growth companies. And I couldn't help but think, is—is this really necessary. My staff also tells me that in February 2017, the social media company Snapchat filed for an initial public offering, claiming EGC status.

And I am pretty sure that the IPO was overprescribed with many investors clamoring to buy up its shares. Now, the same thing happened in March with Dropbox when they went public in an oversubscribing offering, claiming EGC status. So a lot of these discussion drafts and bills amount to a drip, drip erosion of our security laws.

And I am somewhat worried we may be ignoring the needs of investors and marketplace transparency. And so I am—this subject of Expanding the On-ramp reports that many of your—our witnesses have worked on. But a common trend that I have noticed in these proposals is that there is only one direction we go when we balance investor protections versus expanding access to capital. And that direction is always weakening of our disclosure requirements.

Now, Mr. Gellasch—is it Gellasch? I am sorry. Gellasch. I really was intrigued in your testimony because you stressed the importance of considering the impact of these proposals on investors who are contributing to the capital. So could you describe how expand-

ing regulatory accommodations for users might affect the attractiveness of U.S. companies to investors?

Mr. GELLASCH. Yes. Thank you for the question. I certainly appreciate it. So as we have talked about the explosion of private capital and—and Professor Coffee agreed that—he said, gee, there may not be all of this need for capital formation. It is just not—

Mr. SCOTT. Yes.

Mr. GELLASCH. In the public markets anymore. We have to think that when we talk about some of the proposals before us, we are trying to make—give—make those investment opportunities more accessible for retail investors. Well, pension funds and big mutual funds are how the predominant number of actual retail investors invest. And the people who have the fiduciary duties to them are saying these private markets are too costly, generally, and too risky, generally, for us.

And so when we talk about expanding the private markets and making them more accessible to folks, we are not actually going to get those people more involved. At the same time, when you are looking at the public markets and focusing on the burdens and costs and risks of issuers and the folks that are trying to sell their securities, we are saying, hey, you, the investors in those public securities, we have a great deal for you. It is less.

You are going to have less transparency, higher costs, and higher risks.

Mr. SCOTT. And Mr. Coffee, you agree with Mr. Gellasch on this—my concerns?

Mr. COFFEE. I agree mainly with your point that—that the hope for more IPOs, we shouldn't eliminate, abolish, and downsize all of the protections that give shareholders some right to comment on and criticize corporate behavior. Earlier it was mentioned that there is a shareholder proposal rule. And that would be downsized by a resubmission provision. I have to tell you that empirically, there is a study that shows since 2000, 50.1 percent of shareholder proposals have gotten less than the 30 percent level at which they would be cut off—

Chairman HUIZENGA. Gentleman's time is expired.

Mr. SCOTT. Thank you, Mr. Coffee. I appreciate the extra minute, too, Mr. Chairman. Thank you.

Chairman HUIZENGA. Gentleman's time is expired. I now recognize myself for 5 minutes. I want to first address my initial questions to Mr. Knight, if I may. And I know this is slightly off topic for the hearing today, but since you are here, I would value your testimony on legislation that I have introduced to amend the risk- and leverage-based capital rules for banks in order to improve liquidity for listed options.

I have several questions I am going to go through, and then if I could get your response. One, I wondered if you could discuss how improved liquidity decreases spreads and makes it less costly for investors to make use of listed options. And if you also discuss the importance of liquidity in options markets when there is volatility for the underlying assets.

For example, how important is it to have the ability to manage risk through options when there is volatility in equity markets. And then is it fair to say that this is a timely issue that the Fed-

eral Reserve and other banking regulators should address as soon as possible, and do you share the concern that the timeline for implementation of this standardized approach for counterparty credit risk, which proposes to amend the treatment of options and capital rules, is too far off? They are saying maybe a couple years away.

So several questions there, but wondered if you could respond to that, Mr. Knight.

Mr. KNIGHT. Certainly. The options market is critical to the management of risk in the underlying cash equities market. It is a market that is populated mainly by professional traders, by market makers on behalf of financial institutions and investors who are laying off risk through the investment in options.

It is a critical market to our economy. Central clearing of those instruments provides stability to the economy and something that is encouraged across markets. The rules that apply there don't necessarily recognize the capital structure and the investment policies of some of the midsized firms that are populating that market and may cause a reduction in their participation in those markets.

There are alternative, more modern capital markets, capital requirement markets for the central clearing houses that the Fed could consider that would preserve the participation of those mid-level market makers, which would provide more price discovery participation and that would narrow the spreads and narrow the cost to the investing public.

Chairman HUIZENGA. Thanks, Mr. Knight. I appreciate that. I am going to move to Mr. Paschke if I could. I am interested in the part of your testimony that discusses the diversified fund limits under the Investment Company Act. I don't believe this is something we have spent much time discussing here on our committee. I wondered if you could discuss the history of the 10 percent limit on mutual fund positions.

Why does it matter if a mutual fund owns 10 percent or even 50 percent of certain company as long as the overall fund remains diversified? And why do you believe it would be appropriate to increase this limit to 15 percent for diversified funds?

Mr. PASCHKE. So the—the point of the rule itself is just for clarity to who you are investing with and alongside and particularly it is relevant now with the activist rules and activist campaigns. Why moving the 10 percent up to 15 percent as relevant to today's conversation has been one of the—the shining lights of the JOBS Act passage has been the proliferation of life sciences companies.

I think the statistic that came out earlier is 260 life sciences companies have gone public since the JOBS Act. Those companies by and large tend to be very small. They are taking drugs through the FDA process. They haven't built out a full staff. They also have a specialized group of investors who invest in portfolio theory across those 260 in many cases because some are going to hit and some are going to miss.

So to limit those specialist funds' ability to invest into those funds to help fuel that drug discovery, lead them through the FDA process to get them to a point where they are able to commercialize. I think this really expands the opportunity for them to get the funding they need from high quality specialist funds. Ten percent limit on a company that may come public at a \$75 million or

\$100 million market gap, there is only \$7.5 million or \$10 million. It is often insufficient in order to move the drugs to the FDA.

Chairman HUIZENGA. Thanks. Mr. Hahn, I am wondering, do you agree that mutual funds are needlessly restrained in their ability to invest in startup companies because of this 10 percent limitation in the Investment Company Act? And what will increasing this limit mean for the ability of startups to access the capital they need to grow?

Mr. HAHN. When GlycoMimetics was private, we raised about 65 million. It took us over a year to raise that last 38 million. One of the main reasons we went public in 2014 was access to capital markets and the quick ability to raise funds. Since we have gone public, we have raised over 300 million in the public markets, so access to larger investments, we would welcome that. We raise money with this. It is a large anchor investor we are looking for. As I was saying, more than—we are looking for a \$20 million to \$30 million investment from any quarter, not just \$5 million to \$10 million.

Chairman HUIZENGA. Thank you, Mr. Hahn. My time has expired. Next, I will recognize the gentleman from Connecticut, Mr. Himes, for 5 minutes.

Mr. HIMES. Thank you, Mr. Chairman and thank you gentlemen for—for really interesting presentations. I was there when we were doing this in the original JOBS Act and participated in its formation and ultimately, despite a few reservations out was happy with its passage.

This conversation actually allows me to resurrect a not entirely dead horse to beat a little bit, because I was always struck, though I was a supporter of the JOBS Act, the best estimates I could get at the time was that the Sarbanes-Oxley and other compliance regimes probably imposed in the neighborhood of \$1 million to \$3 million a year of compliance costs, which is real money, but as a guy who used to do IPOs, I was always struck by the fact that I couldn't get anybody to focus on the other area or another area in which there is a lot of money out the door, which of course is the gross spread paid by companies going public.

So I did some studies and lo and behold, there are studies out there that show an absolutely remarkable consistency in pricing of IPOs of 7 percent. It almost never changes for midsized IPOs. I have been crying in the wilderness. I have had a hard time getting, FINRA (Financial Industry Regulatory Authority) and SEC, and I have letters here promising studies and monitoring.

And the SEC told me that it is hard to establish the cost incurred by underwriters, it is not. I have done it. And I just haven't gotten any traction until recently when SEC Commissioner Rob Jackson came out with a speech in April that called the history of the gross spread pricing a middle-market IPO tax.

So I get to beat this hopefully not dead horse. Mr. Eggers, I am going to start with you. Does perfectly consistent 7 percent gross spread IPO pricing and the cost that imposes which, as you know is \$14 million to \$20 million, does that—this comes out of your pocket, issuers' pockets and IPO investors' pockets. This—does—does the seven—perfect consistency of 7 percent gross spreads in

this country and not anywhere else in the world, does that feel to you like a competitive market?

Mr. EGGERS. No, it doesn't. Remember in the late 1990's, we had the Four Horsemen which were a midmarket group of bankers that would take companies public. Those—all those companies are gone, so we have fewer bankers that generally take companies public. Most the time, our best companies want to be taken public by someone like Morgan Stanley, Goldman Sachs, or J.P. Morgan, so there is less competition than there used to be, to answer your question.

Mr. HIMES. So I have had a hard time, in addition to getting FINRA and SEC interested in this until Commissioner Jackson gave his speech, I have certainly had a hard time getting the venture capital community, which I know well, interested in pushing on this. Why is that?

Mr. EGGERS. I—I would be happy to push on this.

Mr. HIMES. OK.

Mr. EGGERS. I think it is an important—

Mr. HIMES. Mr. Hahn, you went—thank you, Mr. Eggers. Mr. Hahn, you went public. Do you agree with Mr. Eggers that this doesn't feel like a competitive market?

Mr. HAHN. Bankers are helpful in accessing the capital markets.

Mr. HIMES. I know, I was one. I am just asking whether the fees they charge are emerging from a truly competitive market.

Mr. HAHN. You know, it is always been set at 7 percent, so it is something we really just didn't question. So now I think it should be looked at.

Mr. HIMES. OK. Mr. Knight, Rob Cook responded to my request for a study—because look, I have looked at the academic literature and it is pretty clear, but I don't know everything. Rob Cook is a good friend, by the way. We were in college together and despite that, I have not been able to extort him into—into doing this study. FINRA in January 2017, his letter said that you support a comprehensive assessment of the IPO market and gross spreads attendant. Have you actually undertaken that comprehensive assessment?

Mr. KNIGHT. Of the IPO market?

Mr. HIMES. Of gross spreads in the IPO market?

Mr. KNIGHT. Well, we study all aspects of the market. I have to tell you, I am not familiar with what our chief economist has there, but we may have. And if we do, I will supply it to you.

Mr. HIMES. So I am in a little stronger position than I was when we had this correspondence. Mr. Eggers, who knows the venture capital community pretty well and Mr. Hahn, who had the experience of this have both agreed that this doesn't feel like a competitive market. The numbers we are talking about here dwarf the compliance costs that if we have a perfectly calibrated JOBS Act, they dwarf the numbers that we are talking about.

So now I have finally gotten SEC commissioner in some fairly public statements on this, will FINRA undertake this study with the SEC to determine whether gross spread pricing for midmarket IPOs is truly competitive, or whether there is some oligopolistic behavior?

Mr. KNIGHT. I am not with FINRA. Nasdaq is independent of—

Mr. HIMES. I am sorry. I apologize for that, I misread your—

Mr. KNIGHT. I was at one time, but we are not—

Mr. HIMES. OK. OK, I apologize. I don't mean to put you on the spot.

Mr. KNIGHT. No, frankly, what we see is a lot of competition amongst the banks to take companies public, the pricing issue is a separate issue, but they are certainly competing out there to get those assignments and we have not seen signs of a lack of competition. Of course, Spotify recently took a different model and avoided that. So there is competition and models that are—that is emerging. And as technology changes here, I think you are going to see more innovation.

Mr. HIMES. Thank you, I yield back.

Chairman HUIZENGA. The gentleman's time has expired. With that, the gentleman from Maine, Mr. Poliquin is recognized for 5 minutes.

Mr. POLIQUIN. Thank you, Mr. Chairman very much. Gentlemen, thank you all for being here today, I really appreciate it. Now I know you have very stressful jobs, very stressful jobs, and I have some great news for you—

Chairman HUIZENGA. If you will allow the Chairman to interject.

Mr. POLIQUIN. Yes.

Chairman HUIZENGA. There will not be additional time for the PSA for Maine tourism.

Mr. POLIQUIN. Well, Mr. Chairman, on Maine's license plate, it says Vacationland. I want to make sure all these wonderful people in this room know that as you are planning your summer vacation, we don't even need air conditioning up there, we have moose walking around, all kinds of other critters, lobster, blueberry pie. You need to go to Maine where you belong, with these stressful jobs. And—and I think your families will thank you for that, and if you can put another 35 seconds back on the clock, I would be very grateful, Mr. Chairman.

Chairman HUIZENGA. Motion denied.

Mr. POLIQUIN. Now, there seems to be all this bad news that circulates in this town. I am not used to that. I represent the rural part of Maine. And we have a great problem to have up in Maine. We can't find workers. I know the national unemployment rate is about 3.9 percent. We are at 2.7 percent. And I don't care if you want to have folks working on the docks or picking apples or working in precision machinery, we can't find those bodies.

Business confidence is through the roof, consumer confidence is high, we have seven million job openings across this country and it is all because—we know what it is. It is because regulations now are more predictable and there are fewer regulations. And the equity market is a forward-looking animal and they are looking at that and they are discounting it. On top of that is that we have lower taxes, so our families can keep more of their own money and spend it the way they want to spend it.

And our businesses are growing. And they are investing. And Maine's second district is an economy of small businesses. Now, one of the things that keeps me up at night is how do we make sure there is access to capital so our businesses can grow—all sizes.

And some folks borrow money from banks and that is all great—or credit unions. Some folks have access to capital markets.

It is critically important to make sure we keep these reforms going. I—I am going to tell you what you folks already know. If we start raising taxes, if we start layering more and more regulations like we have been the last 10 years, we are going to be growing at half what we are growing at now. And when the economy grows, it is great for everybody. So one of the issues is how do we make sure these reforms continue.

Now we all know what the stats are the last 5 or 10 years, the number of companies that have gone public have about cut in half, roughly. I would like to know, Mr. Paschke, when you talk to folks in the board room—Mr. Knight probably another good person to ask—what are they telling you? Are they telling you what we heard from Mr. Coffee a short time ago?

What are their concerns and why are they choosing to stay private instead of going public? And second, a follow up question. We now have a new SEC. You folks, for the most part, deal with the SEC on a regular basis. Do you see a change over there where these folks want to be helpful and not layer on and make it more difficult for you folks?

Tell me what you see out there so we are apprised of what needs to be done.

Mr. PASCHKE. So answer two things very quickly—

Mr. POLIQUIN. And speak right up, sir. Get right in that microphone.

Mr. PASCHKE. So answer two things very quickly. One, we just had a very productive working session with the SEC about 3 weeks ago, a group that SIFMA had organized. Very constructive, very roll up your sleeves, very specific—

Mr. POLIQUIN. Was Mr. Clayton in the room?

Mr. PASCHKE. He was not but he then circled back with feedback on—he had heard it was a very constructive—

Mr. POLIQUIN. Good.

Mr. PASCHKE. So early returns feel quite good in that regard, and constructive. The second thing you talk about, what do they say about why they want to stay private. One is you can structure those investments however you want. But the other part of this whole discussion that hasn't been talked about in terms of why didn't we see a huge jump in IPOs right after the JOBS Act, we have been operating in a near 0 percent interest rate environment.

Mr. POLIQUIN. Right.

Mr. PASCHKE. There has been so much access to alternative forms of investment.

Mr. POLIQUIN. Right.

Mr. PASCHKE. You know, direct private investment on the equity side or very cheap debt on the debt side, that has had a major impact. As you see rising rates, what you are seeing actually is an increase in equity offerings from existing public companies. There is too much of an on-ramp for the IPOs to have caught up to the changing environment.

But that is going to change. And I am going to highlight—the one thing I keep highlighting here is for your district in Maine, the other way for those people to get wealth is to be able to invest in

the public markets. They do not participate in the wealth creation that occurs in the private markets.

Mr. POLIQUIN. I worry about our small investors in Maine, folks that are working on the docks or working in the woods or pulling traps or—or growing potatoes and these folks are saving as much as they can every week to go into a retirement nest egg or to save for their kids' education. And a lot of those investments—not all but a lot of them, as you mentioned earlier—I am not sure if you did, Mr. Quaadman, mention this—through retirement funds.

I guess it was Mr. Gellasch—through State and other private employee benefit funds. So there are a lot of folks in this country, a lot of folks in our district who are owners of corporate America and it is really important to make sure these regulations are helpful to them so they have a better opportunity to live better lives and more freedom. With that, are you going to award me, Mr. Chairman, another 35 seconds that I rightly deserve?

Chairman HUIZENGA. The fine folks at PureMichigan.com have asked me to evoke your time. So the—but with that, the gentleman's time has expired.

Mr. POLIQUIN. Thank you very much.

Chairman HUIZENGA. All right. That would be PureMichigan.com. And with that, the gentleman from Ohio, Mr. Davidson, is recognized for 5 minutes.

Mr. DAVIDSON. Thank you, Chairman. And I really want to thank our witnesses. Thanks for the time you have committed to be here today and for the work you do to advance capital formation, particularly with our small companies.

And Mr. Eggers, I wanted to talk about venture for a bit and just the important role that venture plays in helping so many Americans realize their version of the American dream.

Starting and growing a company in America is trending in the right way. For a long time, we were seeing more companies go out of business than launch. We have seen challenges in companies scaling. And I guess I am curious as you think about companies that want to access public markets, to go from a privately traded founder capital to maybe a round of venture funding.

One of the keys to getting scale is that next round of capital. It is one of the keys where the venture folks get paid for the risks that they have taken. How have you seen the impact of the JOBS Act or other small capital formation initiatives on the space and particularly with information coverage, the research coverage for small companies? Could you address that?

Mr. EGGERS. Yes, thank you for the question. I think the JOBS Act has been effective in certain areas. And I mentioned the confidential disclosures and ability for a company to test the waters, so to speak, before they file, reduced reporting requirements, although when they get to a certain level, those go away. But there are other fundamental issues that also factor in to the problem of less IPOs.

There is the uncertainty in the market once they are trading, the—the culture of short-term-ism, whole bunch of stuff like that. Let me—let me tell you a story about one of our companies, AppDynamics. Was one of our really fastest growing companies in the private area and raised a lot of venture capital and wanted to

go public. Went, hired bankers, paid—paid that 7 percent. Or they were going to pay that 7 percent.

They went through their road show successfully and they were going to price the next morning and they decided instead to get acquired by Cisco Systems. Obviously for a premium on how they would price, but it makes you wonder why a company like that, a very good company, high-growth company that has created a lot of jobs would take the certainty of an acquisition over the uncertainty of the public markets.

Mr. DAVIDSON. Yes. Thanks. Good—good explanation. Mr. Quaadman, how—do you see provision of the JOBS Act—have you seen it boost coverage in pre-IPO, particularly for EGCs?

Mr. QUAADMAN. It has been mixed. I think the testing the water provisions certainly have helped, but I think in terms of research, it is been mixed. We still see a dearth of research for smaller issuers. So I think the—the draft legislation here, I think is going to be an important way to help incentivize some more of that research, which that research will then also help drive liquidity investors to those companies.

Mr. DAVIDSON. Thank you. And maybe for the group, I am working on an ICO bill, so when you look at companies that choose to raise capital through an initial coin offering—we are trying to get our arms around how early formation is different. It seems that a lot of the things in—in the JOBS Act, in—in—perhaps even in EGC designation, or Reg A+ could help. Have any of you spent time thinking about this with respect to ICOs?

Mr. QUAADMAN. Mr. Davidson, this is something where we have put together a group of companies to look at this, and we have actually had some meetings with Treasury, some meetings on the Hill as well, and we are trying to determine if that is a way of helping with capital formation, but we also have concerns about investor protection as well. So I think that is something we would like to have a further dialog with you on.

Mr. DAVIDSON. Thank you.

Mr. GELLASCH. If I may, Mr. Davidson, on the investor side, I would like to echo those remarks. Obviously, coin offerings have exploded themselves, and there are a lot of interesting issues related to that. Are they securities, for example, is a really basic question that the regulators are wrestling with.

One of the things I—I think—and you mentioned alternatives there, thinking about do we put these things in the registered public space, the traditional public space, some scaled-back version of that? Do we go even further into a Reg A+ type of model?

I would encourage you to think about those things very carefully, because the Reg A+ experience is remarkably different than the ECG experience. So as you think about alternatives, I would encourage significant caution.

Mr. DAVIDSON. Yes, thank you for that, and clearly some would—would still qualify as commodities, as CFTC has tried to make clear. So talking secure—where does that line exist—and my time is expired. Mr. Chairman, I yield.

Chairman HUIZENGA. The gentleman's time has expired. I am not seeing—no further speaker—questioners on the—on the Demo-

ocrat side at this point. The gentleman from North Carolina, Mr. Budd, is recognized.

Mr. BUDD. Thank you, Mr. Chairman, and again, thank you all for coming today and for your time and your input and your insight.

So this is an important hearing, and one that is timely considering that Chairman Huizenga is negotiating a package of bills with the Senate that will focus on, yet again, capital formation. These bills would include some that have already passed the House, including my own bill, H.R. 3903, which is encouraging public offerings, and possibly some proposals before the subcommittee today.

I want to go back again, to continue on with what Mr. Davidson was asking about the JOBS Act, and Mr. Quaadman, can you please explain some of the regulatory requirements that emerging growth companies are exempt from under the JOBS Act in their on-ramp provisions?

Mr. QUAADMAN. Sure. There are certain executive compensation disclosures that they are exempt from. There are certain—there is the potential for certain exemptions from new audit or accounting standards as well.

And generally, it provides for disclosures, but done in a slimmed-down version that allow for investors in those companies to get the information that they need. And it also allows for some of the more costly disclosures, such as—let us say, conflict minerals or others that they are exempt from also.

So it is a way of allowing companies to grow into the existing public company system, and to eventually ramp up. Because one of the problems at Sarbanes-Oxley was that internal controls and all are extremely important. It was trying to make some of the costs scalable, and effectively what the JOBS Act tried to do in a very broad way was to make it scalable and ensure that their investors are receiving the information that they need, as well as have the protections in place.

Mr. BUDD. Very good. So why are—and you answered some of this next part, but why are the exemptions provided in Title I so necessary for emerging growth companies? If you care to elaborate any more on that, maybe some other reasons?

Mr. QUAADMAN. Yes, it is their investor base is more interested in some of the things that the company is doing rather than what its sales are at that time. So it is—investors are much more forward-looking there.

It—it also—as I said, it allows for an ability for a company to gradually work its way into a public company model, because regardless of some of the discussion we have had here this morning, we have built in a lot of inefficiencies into the public capital markets. And what—effectively, what the JOBS Act tries to do is tries to shield those emerging growth companies from some of those inefficiencies to—until a point where they can deal with it.

So we actually view the extension from 5 to 10 years—will actually allow for existing EGCs a little more time, and will also continue to make EGC—the EGC model a more attractive one.

Mr. BUDD. So why are things like the say-on-pay provisions—why are they not appropriate for these small EGCs?

Mr. QUAADMAN. Well, first off, say-on-pay passes with 95, 90 percent with large public companies. And we have also had an issue—we don't have—necessarily have an issue with say-on-pay itself. Investors should have a dialog with companies about executive compensation. But what has happened with the proxy advisory firms is that they have required a year by year vote, whereas Congress said, investors can decide what the frequency is.

So rather than have an entity or a duopoly like the proxy advisory firms place a very costly provision on EGCs, Congress is actually somewhat going back to the intent of Dodd-Frank with say-on-pay to actually allow companies some breathing room with that.

So that is one where I think, again, it is something where you have a founder-type system with EGCs, which you probably primarily have; investors are as invested in that founder as they are with the company itself. So, say-on-pay is a less relevant tool than it is for, let us say, a more mature company.

Mr. BUDD. That makes sense. Thank you, Mr. Quaadman. Mr. Hahn, since the enactment of the JOBS Act, about 265 biotech companies have used provisions in the act to go public. A lot of those are working on research that is ultimately going to save lives. Can you discuss with us in the partial minute that we have left how the on-ramp provisions have helped these companies better allocate their resources?

Mr. HAHN. I think the biggest provision that helped us was test-the-waters. So, we have complex science, and getting investors up to speed to understand the science and to want to invest in the company in the traditional 2-week timespan of a roadshow, we would have lost a lot of investors with that. So test-the-waters gave us the ability to bring those investors up to speed.

And also with the 404(b) exemption we talked about, that helps us save money—divert money into the science instead of a one-size-fits-all regulatory burden.

Mr. BUDD. I appreciate that. I think my time is expired. Again, thank you all.

Chairman HUIZENGA. Amazing self-discipline. A gentleman's time is always ready to expire, so with that, the gentleman from California is recognized for 5 minutes.

Mr. SHERMAN. Thank you. We have a bunch of bills that are designed to help small companies get capital one way or the other. And then included in discussion for this hearing is a bill designed to prevent shareholders from being able to put forward questions for a vote and be included in the proxy statement.

Mr. COFFEE, are you aware of any small startup in a garage that has ever had a second presentation of the same shareholder question in their proxy statement?

Mr. COFFEE. That small startup is the subject of the proxy rules, in most cases, so it is going to be totally inapplicable. But I think you are right in pointing out that unrelated to the IPO concerns of raising capital, there are provisions in here that downsize the shareholder voice in challenging corporate conduct.

And there are other provisions in here that give major exemptions to what are called well-known season issuers, our largest companies, and allow them directly to sell before filing a disclosure document. It has nothing to do with small firms. That is our larg-

est top quarter firms, and it is just a wish list of various deregulatory proposals various people on this committee agree to.

So I don't think there is a clear, rationalized coherence to all of this. But on to your first point—

Mr. SHERMAN. Yes, and I am aware of the social benefit put forward by making these issues come to light, and I think it taints the rest of the bills that we are discussing to throw in here something that has nothing to do with raising capital for small or big companies, and everything to do with suppressing discussion of important issues that face corporations in their operation.

The next point I want to make is a number of the issues come in, how much money will we, as a society, spend on investor protection? And some would say, well, as a society as a whole we are spending a billion dollars on this aspect of investor protection, and maybe we are avoiding a billion dollars of fraud, so that balances out.

No it doesn't, it is a good thing for society, because a billion dollar fraud loss—it doesn't just affect the people who lose their money, it dampens public interest, foreign interest, retail interest in investing in stocks. And having the game be fair is worth every penny that is necessary to achieve that.

Mr. Gellasch, there is this proposal here to slash 404(b) audits, to increase by double or triple the various floors, and in effect say we will save a lot of money on worrying about internal control, and we will maybe only have one or two Enrons a decade as a result, probably a smaller company or smaller examples of that.

What do you think of the need for attestation of internal control and reports on internal control?

Mr. GELLASCH. Well, I think we have seen examples, both—not just Enron, but also in the—in the private company space, like Aranos, where the need for robust internal controls and financials is important, and some of the smartest guys in the room in the private space have proven ineffective at being able to do those things themselves in their own due diligence.

So one of the things that is really important for the public capital markets, as you alluded to earlier, is ensuring that you have investor confidence and you don't lose it. And the accuracy of financial statements is critically important to investors. And so when we think about what the costs are associated with that—and I certainly appreciate and respect those may not be trivial. That is fair.

I think—but that is also—

Mr. SHERMAN. And I could sneak in, it is not just important to investors. You may have some division of a company, or what—where they are having signing parties forging documents for mortgages, et cetera, where you are hurting consumers. How is internal control important for those other than investors?

Mr. GELLASCH. Exactly right. It is a corporate governance issue that is far beyond just an investor protection measure. And one of the things I think we tend to focus on is just the cost associated with that. I would say what is also really important is focusing on that aspect. These are improving the quality of the offerings, including the quality of the companies and how they are governed.

Mr. SHERMAN. I yield back.

Chairman HUIZENGA. The gentleman's time has expired. With that, the gentleman from New Jersey, Mr. MacArthur, is recognized for 5 minutes.

Mr. MACARTHUR. Thank you, Chairman. Good morning. I appreciate all of you being here.

I am proudly wearing this pin—you probably can't see it from back there, but it is a—Foster Youth Shadow Day, and Rishawn, stand up. Stand up. This is Rishawn from my district. Young man—very interesting young man. Very—yes, give him a—give him a hand.

He has an entrepreneurial spirit, I can tell you that just from our conversations this morning. He is doing all kinds of things, and very interested in both philanthropy and in growing a business.

We all know it takes more than hopes and aspirations and dreams and ideas. It takes money and it takes a path that is not completely cluttered with obstacles. I know, because that is the life I lived for 30 years growing a business.

So I am listening this morning—first, I am impressed that he is awake, because some of this stuff could make anyone's eyes glaze over when you—when you listen to this. But—but this translates into real people's lives that want to do things.

And I had—as we do in this business, I had to step in and out this morning, and so I have missed a lot of things, but I was here for the opening remarks. And Mr. Coffee, I was really struck by yours.

It is a great name, by the way, if you weren't a professor, it would be a great name for a business. Mr. Coffee.

That has been done. It took money for them to grow that business. I used to handle their insurance many decades ago. It takes money to grow a business. And I listened to you—I am not meaning to poke fun, I am just—I just was struck by your remarks, and you said that the reason companies don't really need the public markets—it is not because of regulatory overreach or overzealous attorneys general who criminalize management mistakes.

It is none—it is none of that, it is just that companies can get money from the venture world, or the private equity—I think you said the venture world, but I think that may include other—

Mr. COFFEE. Private equity firms also, I said.

Mr. MACARTHUR. Well, sure. Well let me tell you—let me tell you the decision I had to make when we got to a State where my business was big enough that I thought I could go public, and there would be enough float to actually make that viable. We had gone from a hundred-odd people to thousands. We could have done that. Why did I choose something other than private equity?

I just left a meeting—one of the meetings I had to step out for was with a person that works with the exchanges. And I asked her the question, Why don't companies go public? She said the number one reason I hear is they are deathly afraid of overzealous regulators and State attorneys general. That is their number one reason.

And then I think about your remark that, well, it is not that. Underregulation is—is far less dangerous than—or far more dangerous than overregulation.

Mr. COFFEE. Equally dangerous, I meant.

Mr. MACARTHUR. Here is—here is the problem with that. If you really get practical. This doesn't—this doesn't play out—no disrespect intended, but this stuff doesn't play out in a classroom. It plays out in the real world with real pressures coming from all sides. Venture capital, private equity capital, all of it is the most expensive form of capital for a business person to access.

By far the most expensive. More expensive than the public markets. More expensive than debt capital or any of the alternatives around that. It comes with the greatest amount of outside control. Because private equity funds—private equity funds, venture funds, this is what they do every day. And they don't give their money without exacting a price, without getting certain controls, without getting certain investment thresholds.

It is the longest liquidity possible outcome. You take capital from those sources and you are going to wait 5, 6, 7 years or more. So why would a rational business person choose that anyway? Most costly, most control lost, longest liquidity event. Sir, with respect, it is not because it is just easy money and it has nothing to do with the state of the public markets.

I am telling you from personal experience, it has to do with the fact that the public markets are frightening to business people who don't want to get squeezed and attacked and have a management mistake criminalized and all of the other stuff that comes with it. And I don't usually make speeches with my 5 minutes, I usually ask questions but my speech has lasted 5 minutes and so with that, I yield back, Mr. Chairman.

Chairman HUIZENGA. Gentleman yields back. Gentleman from Arkansas, Mr. Hill, is recognized for 5 minutes.

Mr. HILL. Thank the Chairman. I want to thank my friend from New Jersey because of his 5 minute speech, I may—I have more time for questions because I enjoyed it, I associate myself with it and it reflects the experience I have had for 35 years and in corporate finance. So I appreciate my friend Mr. MacArthur and his perspective on the public and private markets.

It has been—it has been said that we want more public companies—all of you agree with that universally—to give more opportunities for our pension funds, our 401(k) plans, our IRA accounts and that there is absolutely no reason to say that is not the primary objective. We want that opportunity because it shares the prosperity of America.

So then it gets down to, well how do we accomplish that. And one is in sales and trading and research and bringing that company out. That is a key component that we are talking about today. And then the other is the cost of maintaining that public enterprise. And so we have bills on both sides of those issues. And I was with a company a couple of weeks ago—it is a publicly traded company, \$2 billion market cap.

One division has 5,000 suppliers. That is a lot. And you can imagine they have a lot of things that they sell to have 5,000 suppliers. But one of the most costly things they have in this public company—long-time public company, \$2 billion market cap—is trying to comply with the conflict minerals rule. It just—it just takes over their whole process, trying to prove that they have done that in case they are sued. Which they of course fully expect to be, be-

cause it is not possible to comply with it with 5,000 suppliers in just one division that—in a globally sourced enterprise.

And so that is an example of what we are talking about, I think, today on the second piece, the cost of maintaining that public enterprise in a competitive—in a competitive way.

Mr. Quaadman, there was a lot of discussion today about studying research coverage for small issuers before they had an IPO. I would love for your perspective on maintaining coverage of a small cap issuer after they are public and then I will ask Mr. Paschke to comment as well.

Mr. QUAADMAN. No, I think—no, that is a great question because we have actually seen some problems with that, where there has actually been a retrenchment of research at times as well. And the reason why I raise MiFID with my opening remarks is that EU rule is actually going to impact research here and is going to impact costs. So it is a matter of—it is a supply and demand issue, right? What are the costs of the research, what are the—how is it priced out?

And it is unfortunate that—I think the JOBS Act tried to address some of that but we actually need to do more of that and we are going to have to try and also determine with the SEC how we also deal with this in terms of MiFID as well.

Mr. HILL. Yes. Thank you. Mr. Paschke, what is your view on that in the marketplace?

Mr. PASCHKE. It is an absolutely major issue. And I mentioned, we cover 600 companies in research with a focus on small and mid cap. And the data shows that for companies with a \$500 million market cap and below, they have an average of about three research analysts covering them. Larger cap often will have 25-plus. So it is very important in those voices that cover them are the voice to the market.

MiFID was an appropriate thing to bring up because most market estimates say that the cost that the buy side is willing to pay for sell side research is going to come down by about a third through unbundling. So if you are a small cap name and there are two or three research analysts covering you today and the research budget just went down by a third, you may lose one to two of them.

Mr. HILL. Yes. I think it is super important and I think this \$500 million number is a reasonable number. The company I referenced, \$2 billion market cap has six regular research firms covering them. I was surprised by that and delighted. And some have long-standing—it is a mix of regional firms and Wall Street firms. In the time I have remaining I just want to bring up one other issue for you representing SIFMA.

Just like we talk about community banks needing relief from regulations, I think the same is true for privately held non-bank broker-dealers. And one of the ways to do that is I have a bill that is going to permanently exempt of the peekaboo standard, the audit standard for small private broker-dealers. And I would hope that SIFMA would look at that issue and be supportive of a permanent waiver, effectively, for the peekaboo standard on audit for a small broker-dealer—because it is introducing—not holding customer funds.

Mr. PASCHKE. Yes. It is my understanding that that was definitionally caught up in Dodd-Frank and that some brokers who probably weren't appropriate the privately held non-custodial brokers, were caught up in some of the regulations, which would seem to us would make sense.

Mr. HILL. Good. I look forward to working with you on that. Thank you, Mr. Chairman.

Chairman HUIZENGA. Gentleman's time is expired with that. The gentleman from Minnesota, Mr. Emmer, is recognized for 5 minutes.

Mr. EMMER. Thank you, Mr. Chair and thanks for the committee—or the witnesses being here today before this committee and your patience. The Treasury—and Paschke, I will start with you. I am going to read you a statement from—an October 2017 Treasury Department report. This I think goes to something that you started to talk about a few questioners before and that frankly, Chairman Huijzena brought up at the very beginning of this hearing today.

The quote is this. Or the Treasury report noted that, quote, “to the extent that companies not to go public due to anticipated regulatory burdens, regulatory policy may be unintentionally exacerbating wealth inequality in the United States by restricting certain investment opportunities to high income and high net worth investors.”

And isn't that what we are talking about here today with these—this isn't just pro-growth, but of the 11 bills, much of it is addressing the fact that you have to be too big to play in this country today. And the thing used to distinguish us from every other country on the face of planet is that any rank-and-file member of our society who wanted to participate in the marketplace, to grow his or her wealth and help grow the wealth of this great Nation, that has been restricted over the last many years and isn't that exactly what you were trying to get to earlier?

Mr. PASCHKE. I think it is absolutely one of the most fundamental issues that is going on, is who can participate in the wealth creation. You know, for sure, the small individual retail investor who has no access or idea about the opportunities and is excluded.

It is even gotten to the point where the mutual fund, active fund managers who are often managing money on behalf of a lot of small individuals or pension funds or police unions, whatever it may be, they are complaining that because companies are going public either later or never at all, that they are missing out on the entire wealth creation that occurs with an Uber or a Spotify or wherever it may be. These companies have achieved huge valuations all through private capital.

So it is not just mom-and-pop retailers, it's active money management funds who don't have access to the private investment either who are one more step away from the individual.

Mr. GELLASCH. If I may for a moment, is to—one thing I think that is important though, is they all actually have—those investment advisors and pension funds actually are likely to be able to physically have access to those markets. The reason why they are not accessing them right now is because of the risks and costs asso-

ciated with a lot of those investments. Every mutual fund or investment advisor.

Mr. EMMER. So you disagree with the Treasury's statement?

Mr. GELLASCH. No, I actually wholly agree. I think that we have to recognize that one, when you bifurcate the retail investor of ma and pa with an Etrade account from the mutual fund investor or the pension funds, which are in fact, the majority of how Americans actually invest in these companies, and those folks who are the fiduciaries, who are in charge of those, are actually saying, look, we actually do not want to and have investment guidelines that say we are not going to get involved, or we are to a very small extent in these private offerings; we are in venture investments in large part because of the costs and risks associated.

Mr. PASCHKE. Which is exactly the point that was made by the previous speaker, about it is the most expensive capital out there. So to say that the private companies ought to be going there instead of public—

Mr. EMMER. And that is what we are trying to address. That is exactly what we are trying to address.

Mr. Knight, I have the venture exchange bill and I appreciate in his remarks, his opening remarks, Professor Coffee likes the concept but has some issues with how it is drafted. Can you—I know you are familiar with this set provision, can you give us just a picture of what it would look like if an entity was going to apply to become a venture exchange? What would they do? What is the timeline with the SEC?

Mr. KNIGHT. The SEC would have 6 months to determine whether they meet the qualifications to become the venture exchange. On our market, we would already be qualified, and the issue would be whether the company would choose that market structure, that the optionality that is in your legislation, that it would allow the aggregation of trading interest in—in one market.

Right now, it is split amongst 50 with work—which works well when you are trading Amazon, but it tends to drain the liquidity away from the price discovery process. We tend to be very focused in the United States on competition between marketplaces and don't focus enough on having the competition or price discovery between orders and quotes, and that needs to be aggregated, particularly for small companies if you are going to have a liquidity thickness that you need so that people can sell securities by securities on an orderly basis.

Mr. EMMER. Thank you. I see my time has expired.

Chairman HUIZENGA. The gentleman's time has expired, but this has been fascinating, very helpful. And I would like to thank our witnesses today for their testimony. Without objection, I would like to submit the following statements for the record from the Equity Dealers of America. My Ranking Member, Mrs. Maloney, had taken care of a couple others earlier.

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 ob-

jection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

[Whereupon, at 12:05 p.m., the subcommittee was adjourned.]

## **A P P E N D I X**

May 23, 2018

Statement of Professor John C. Coffee, Jr.  
Adolf A. Berle Professor of Law  
Columbia University Law School

at

Hearings Before the Subcommittee on Capital Markets,  
Securities, and Investment

of the

Committee on Financial Services

of the

**United States House of Representatives**

**“Legislative Proposals to Help Fuel Capital  
and Growth On Main Street”**

or

**“The Irrepressible Myth That SEC  
Overregulation Has Chilled IPOs”**

May 23, 2018  
Room 2128 of the Rayburn House Office Building  
Washington, D.C.

Chairman Huizenga, Ranking Member Maloney, and Fellow Members of the Committee:

I. Introduction

I thank you for inviting me. I have been asked to comment on eleven proposed bills, all of which seem to have a common source: a 2018 Report, entitled “Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public,” prepared by Sifma and several other industry organizations.<sup>1</sup> The common premise of these bills and the “Expanding the On-Ramp” report is that high regulatory costs and burdensome SEC rules discourage many private companies that would otherwise go public from doing so. That was also the premise of the JOBS Act, enacted in 2012. This premise is a myth, but it is persistently asserted by industry groups seeking to enact a “wish list” of deregulatory reforms.

In that light, and because time is limited, let me make some very basic points:

1. IPO volume crashed in 2001 and has never returned to pre-2000 level.
2. The JOBS Act did nothing to turn this problem around, and indeed IPO volume in 2015 and 2016 was lower than in many years before the JOBS Act.
3. If high regulatory costs and SEC overregulation were a cause of low and decreasing IPO volume, this would be a uniquely American problem. But it is not. IPO volume has declined even more dramatically in Canada and has declined on a level comparable to the U.S. in Europe and Japan.

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<sup>1</sup> The other organizations include: (1) The Center for Capital Markets Competitiveness, (2) The American Securities Association, (3) The Biotechnology Innovation Organization, (4) The Equity Dealers of America, (5) Technet; (6) Nasdaq and (7) The National Venture Capital Association.

Because Canada has no national securities regulator, the decline of IPOs in Canada cannot be blamed on an over-regulating national regulator.

4. What then does explain the decline in IPOs? Although there were scandals in 2001 when the “Hot Issue” IPO bubble collapsed (which suggests that under-regulation may be a partial cause), two basic causes of declining IPO volume stand out:
  - A. Private companies find it easier, quicker, and cheaper to raise capital in robust private equity markets (where litigation risk is also much lower); and
  - B. IPOs for smaller firms have been consistently unsuccessful for a sustained period, losing money for all concerned (both investors and underwriters). Thus, analysts and underwriters tend to shun such offerings. Academic research suggests that the relative disappearance and inprofitability of smaller firm IPOs is because such firms cannot gain the economies of scale and scope than are increasingly necessary to compete in a globalizing marketplace.<sup>2</sup>
5. Is there a crisis? NO! Private companies are tapping ready sources of capital in venture capital and private equity markets. High tech firms (such as Dropbox this year) are doing successful IPOs (but they appear to be mainly motivated more by a desire to provide liquidity to their employees and other holders of their stock options). Other firms (such as Spotify) have pursued “direct listings” (probably again to obtain liquidity for

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<sup>2</sup> See Jay R. Ritter, Xiaochui Gao Bakshi, and Zhongyan Zhu, “Where Have All the IPOs Gone?,” (available on SSRN at <https://ssrn.com/abstract=1954788>).

employees and stock option holders) and have spurned the format of the classic IPO.

6. What will happen to the smaller firm that cannot access the IPO market?

Venture capital firms have long known that prices and premiums are higher in the “M&A” market than in the IPO market. Simply put, the smaller firm can be sold at a higher price/earnings multiple in the M&A market (where the buyer is acquiring control and will therefore pay a control premium). Such a buyer can transform the acquired business and move it to a global scale.

7. In this light, relaxing disclosure and transparency rules and downsizing important corporate governance protections (such as “say on pay” or the Rule 14a-8 shareholder proposal rule) represent a dubious policy for Congress to follow. That is, it is no favor to the retail investor to allow smaller companies to escape full disclosure or to avoid corporate governance norms, when these are precisely the offerings most likely to fail.

8. One last general point: A number of these bills amend or modify specific, existing SEC rules (such as Rules 139, 163 or the rules under the Investment Adviser Act). This amounts to micro-managing the SEC. That might be justified if one does not trust the SEC or considers it hopelessly committed to over-regulation. But this is a Republican SEC and I have not heard anyone describe Chairman Clayton as opposed to de-regulation. In that light, it would make far more sense for Congress to ask the SEC to

study a proposed rule change and report back within a defined period.

After all, the SEC can respond in a more nuanced way and has greater expertise and experience. The SEC can also adjust its rules in a more flexible fashion, while Congress adopts permanent rules, carved in stone.

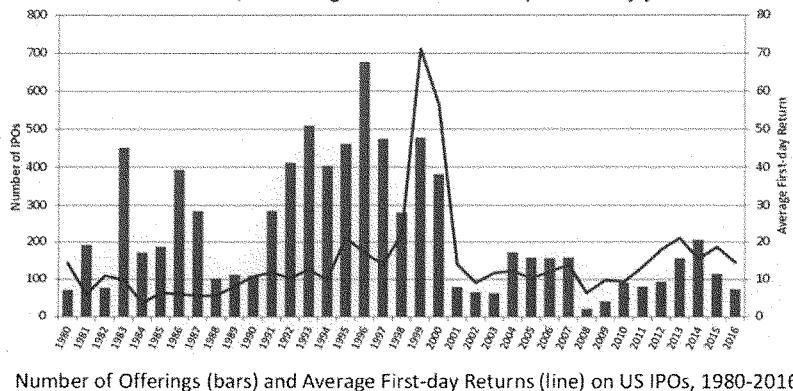
## II. The Empirical Evidence on IPO: Volume and Returns

The basic pattern is shown by Exhibit One, which shows that not only have the average number of IPOs declined (from 310 a year in 1980-2000 to 108 from 2001-2016), but the first day returns (and thus the returns that attract investors and underwriters) have declined dramatically:

### Exhibit One

#### IPO volume has been very low in the U.S. since 2000

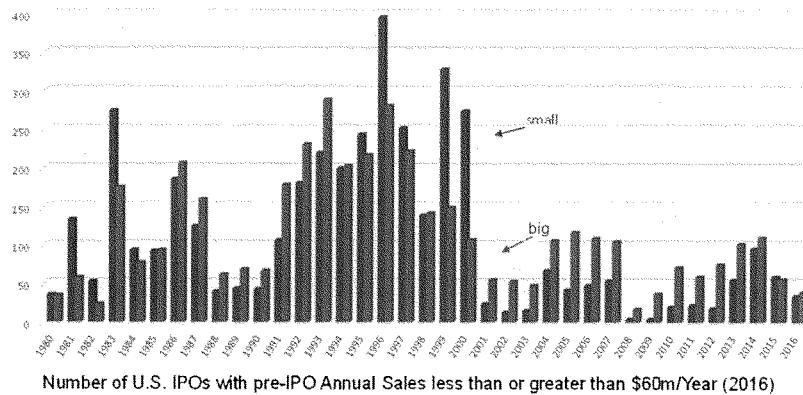
In 1980-2000, an average of 310 firms went public every year  
 In 2001-2016, an average of 108 firms went public every year



This pattern has been even more pronounced for smaller firms (defined as firms with annual sales below \$60 million):

Exhibit Two**U.S. IPO Volume has been particularly low for small firms**

Small firm IPOs are defined as IPOs with less than \$60 million in LTM sales (\$2016)

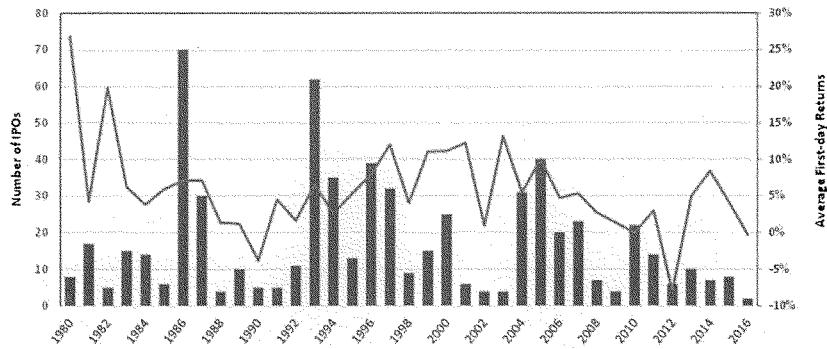


Although “small” IPOs generally outnumbered “larger” IPOs from 1995 to 2000, they have been outnumbered by “larger” IPOs for every year thereafter (with one exception in 2015).

This decline in IPO volume is not unique to the United States. The decline in Canada has been even more extreme (where the absence of a national securities regulator undercuts the argument that overregulation is the cause):

Exhibit Three

Number of Offerings (bars) and Average First-day Returns on  
Toronto Stock Exchange IPOs, 1980 - 2016



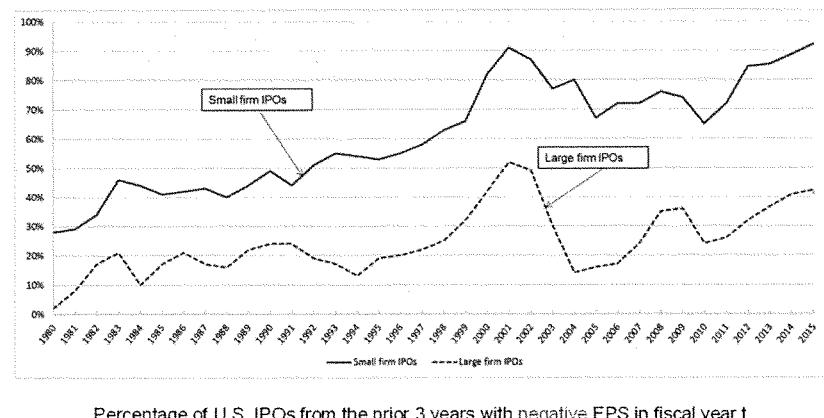
TSX Venture Exchange (and its predecessor, the Vancouver Stock Exchange) IPOs are not included.  
Fund and unit offers are not included (only operating companies are counted).

The Canadian experience is particularly instructive because the first day average returns on IPOs have been negative since 2008 (with the lone exception of 2010). This same decline in IPO volume and returns has also characterized Europe and Japan. Across all the developed securities markets, only China has recently experienced an exuberant and growing IPO market.

Small firm IPOs fare especially poorly in terms of earnings per share (“EPS”) following their IPO. Ritter, Gao, and Zhu measure the percentage of both “large” and “small” IPOs that experience negative EPS in any fiscal year. They find that the percentage of “small” IPOs (from the prior three years) with negative EPS in any given year has ranged between 65% and 90% since 1999. In contrast, “large” IPOs (from the same prior three years) have generally had positive EPS over the fiscal years since 2002:

Exhibit Four

## Small firm IPOs have become less profitable



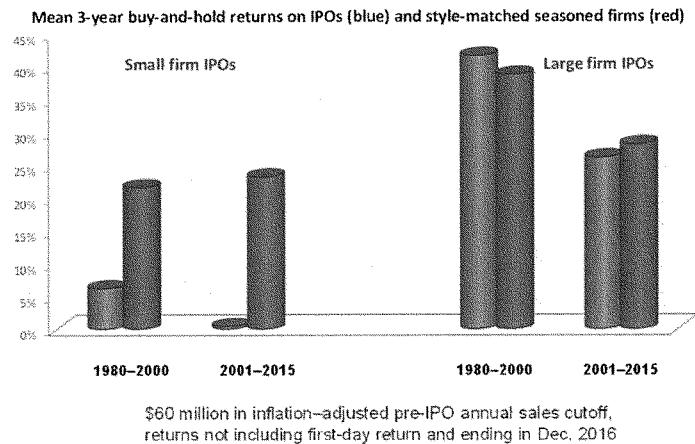
Percentage of U.S. IPOs from the prior 3 years with negative EPS in fiscal year t

Source: Table 2, columns 2 and 4 of Gao, Ritter, and Zhu "Where Have All the IPOs Gone?"  
December 2013 *Journal of Financial and Quantitative Analysis*, updated

In short, large IPOs make money, while small IPOs lose money in subsequent years. The buy-and-hold returns on small IPOs reflect this reality:

Exhibit Five

## U.S. small firm IPO returns have been disappointing



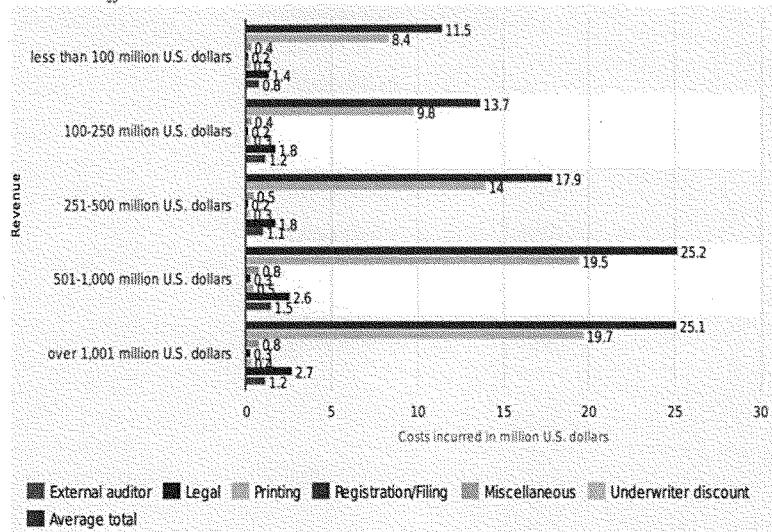
### III. The Cost on an IPO: Direct and Indirect

A key assumption to both the JOBS Act and the proposed legislation before this Subcommittee is that deregulation can significantly (or even moderately) reduce the costs of an IPO. But this is highly doubtful. The following chart, taken from a PriceWaterhouse Coopers study, shows that across all sizes of IPOs (small to large), the underwriting discount accounts for between 71% and 79% of the total average costs:

### Exhibit Six

## The Costs of Going Public

**A. Costs for going public:**  
The chart below shows the average IPO costs in the US in 2012, by company revenue (in million U.S. dollars). The chart indicates that the underwriter discount and the legal fees constitute the biggest share of the total costs.



**Bottom Line:** The underwriters' discount dominates, with legal fees and public auditing costs ranking second and third. Costs directly attributable to the SEC and other regulators are relatively modest. For the \$500 million and larger IPO, the underwriters' discount amounts to nearly 80% of all costs.

Nothing else comes close to the underwriters' discount, with legal and audit costs coming second and third. Legal fees range between 10% to 13% of the total costs. The actual SEC registration and filing costs are trivial and in the 1 to 2% range. Although these proposals might reduce legal and auditing costs somewhat, the reduction would be modest to an already minor cost.

In reality, the "real" costs of an IPO are hidden, and include the costs of diverted executive time, the costs of a now multinational "roadshow," and the potential litigation costs. Some privately-held companies simply do not believe that they can spare time for an IPO when they are locked in intense competition with often larger rivals. Others fear a stock price drop might spur litigation. Still, others doubt that their IPO price

would be as high as their valuation in their last round of private financing (and some recent IPOs have fallen below that level). But these reasons have little to do with the direct financial costs of an IPO.

This is not to say that many private companies would not like to avoid some of the burdens that these bills would spare them from (if they were to go public). Yes, they would like to avoid “say on pay” votes and shareholder proposals by activists (which are made under SEC Rule 14a-8). Similarly, they might prefer a world in which proxy advisors (such as I.S.S. and Glass-Lewis) were closely regulated into relative silence (as is also proposed in “Expanding the On-Ramp”). But such proposals all reduce shareholder rights and involve very problematic trade-offs. Nor will all “emerging growth companies” necessarily be attracted by such deregulation. Suppose, for example, that three new IPOs are caused by eliminating “say on pay” votes for EGCs, but 100 EGCs are thereby deregulated. The costs and benefits of such a move seem open to serious debate. In the next section, some of the specific trade-offs are examined.

#### IV. Proposed Legislation

These bills have very different impacts, costs, and benefits. Thus, each needs to be considered separately:

1. H.R. 5054 (the “Small Company Disclosure Simplification Act of 2018”).

This is “Improvement Nine” in the “Expanding the On-Ramp” platform and it would exempt covered issuers from XBRL (an interactive data format that allows analysts to compare data across companies through a standardized layout). This proposal seems overboard because it would exempt not only EGCs, but also more mature “non-

accelerated filers" that may have been "reporting companies" for many years. Also, there is some inconsistency here between the recurring complaint in "Expanding the On-Ramp" that analysts do not conduct sufficient research on smaller firms and this proposal that makes such research harder (and more costly) to conduct.

Personally, I cannot advise this Subcommittee whether the XBRL format is important in this context, but that is precisely the question that should be asked of both the SEC and institutional investors. As with many other proposals in this package, this proposal seeks to micro-manage the SEC without first inquiring what the SEC's views are.

Overall, this is not among the more important proposals in this package, but some inquiry should be made of securities analysts and bodies such as the Council of Institutional Investors ("CII").

2. H.R. 5756 (Resubmission of Shareholder Proposals Under Rule 14a-8)

This is "Improvement Two" in "Expanding the On-Ramp," and it will be highly controversial. Essentially, it would move the "resubmission" standards up from 3%, 6%, and 10% to 6%, 15%, and 30%, respectively -- in effect, more than doubling them. Essentially, this resurrects a proposal made in 1997, which the SEC dropped as a hot potato. It will be no less controversial today.

Initially, it should be noted that this proposal has relatively little to do with EGCs or IPOs, and would apply as well to IBM, Citicorp, or Apple. Although it would apply to all issuers, it has been endorsed only by representatives of venture capital and other small issuers. Because it very much implicates the interests of "socially

responsible” and “sustainable growth” investors (many of whom are institutional investors and mutual funds), I would urge this Subcommittee to elicit their views on an issue that is important (and even critical) to many of them. In addition, the views of the principal proxy advisory firms (I.S.S. and Glass-Lewis), the C.I.I. and bodies such as the Investor Responsibility Research Center (I.R.R.C.) should be solicited, as their interests are significantly affected and they have closer contact and expertise with respect to the shareholder proposal process than do the proponents of this measure).

In recent years, investors have shown increasingly interest in “Environmental, Social and Governance” proposals (usually dubbed “ESG” proposals and have voted for them in increasing percentages. Such proposals now sometimes win. But typically, they may start with an initially low level of support (potentially, below 6%). Thus, they would be denied resubmission under this proposed standard. Shareholder proposals may receive an initial low level of support because a process of investor education is necessary.

Some institutional investors (most notably, BlackRock) have announced this year that they intend to invest greater resources and personnel in monitoring ESG proposals, and this proposal flies in the face of that enhanced investor interest. Moreover, “Expanding the On-Ramp” cites no data or empirical evidence for its position, but just makes a blanket judgment that shareholder proposals should be cut back. That is too glib.

Shareholder proposals can play a “safety valve” function in corporate governance, allowing issues to be presented that need attention: for example, gender diversity on boards, climate change, executive compensation, etc. This attempt to silence these proposals will do little to encourage more IPOs, but will suppress needed debate.

3. H.R. (“Main Street Growth Act,” providing for the Registration of Venture Exchanges)

The idea of a “venture exchange” is promising and has had some success in the U.K., and Canada but the statutory language proposing this concept unduly restrains the SEC. Under this language, venture exchanges are to be recognized and deemed registered unless the Commission denies the application within six months. Such an exchange may trade securities of any EGC, but other provisions in this package of bills expand the definition of EGC by (i) stripping away the limitation on large accelerated filers, and (ii) allowing firms to continue as EGC for ten years. Further, issuers, trading in this market should be required to make much continuing disclosures as public “reporting” companies, scaled down somewhat to reflect their lesser size. A compromise here needs to be worked out before this idea is truly ready for adoption. These inconsistencies need to be worked out, and it would be preferable if the Commission came forward with its own more nuanced and better researched proposal. Congress should instead encourage the Commission to make such a proposal. Possibly, such a proposal might encourage some “unicorns” to take a half step toward becoming public companies.

Nonetheless, one provision in this bill is especially problematic. Securities traded on “venture exchanges” would be exempted from states’ “blue sky” laws (while securities traded “over the market” on ATS systems are not exempted). This is an unjustified disparity, in part because this is the area of small company trading where the state regulators have been most effective.

4. H.R. (Rule 163)

This bill proposes that Congress rewrite a specific SEC rule (Rule 163), and thus it again seems to be micro-managing the SEC. Beyond that, it also misunderstands the goal of Rule 163. Rule 163 exempts certain very large corporations (known as “Well-Known, Seasoned Issuers” or “WKSIs”) from the gun-jumping rules of Section 5(c) of the Securities Act. This exemption reflects the fact that these large issuers also have the obligation to provide timely information to their shareholders (and hence cannot remain silent as a smaller IPO firm generally can in the “quiet” period). Indeed, its number of shareholders may greatly exceed the number of prospective offerees in an approaching equity offering. But this proposal gives beyond permitting the issuer to communicate timely information to its shareholders and would permit underwriters actually to sell the securities to them -- before a registration statement had been filed. This would overturn a key premise of the Securities Act: that actual selling not occur until the issuer had prepared and filed a registration statement with the SEC that contains all material information about the offering. That would tend to make the registration statement irrelevant or only a souvenir of the transaction. That is, the deal could be entirely sold before anything is filed with the SEC.

Finally, I must observe that this is a proposal relating not to IPOs or smaller firms; but to giant corporations conducting large offerings. It is thus totally unrelated to encouraging IPOs in any meaningful way. Thus, it reveals that the relatively unrelated proposals in this “Expanding the On-Ramp” are simply the “wish list” of a variety of industry groups -- without any close connection or logic. This idea has also been floated in the past and abandoned by the SEC -- for good reason!

5. H.R. (Directing the SEC to increase and align the smaller reporting company definition and non-accelerated filer thresholds).

This is Recommendation One (at p.27) of “Expanding the On-Ramp’s” “Recommendation Related to Financial Reporting.” As proposed in that document, the SEC should conduct an elaborate rulemaking “study of the costs and benefits of such an approach.” However, the proposed legislation simply directs the SEC to take very specific action with very specific thresholds and thus abandons the idea of a rulemaking study. That is unwise. Administrative agencies have greater experience and expertise than Congress and are better positioned to draft bright-line standards.

Again, this bill reflects a certain distrust of the SEC, which seems peculiarly inappropriate when the SEC has a cautious, careful Chairman that no one has accused of a bias towards over-regulation.

I take no position of exactly where the thresholds should be but only suggest that this question needs objective study.

6. H.R. (mandating SEC study of research coverage of small, pre-IPO issuers)

I have no objection to such a study (and would encourage it), but I do anticipate some of the likely findings. Because smaller IPO offerings have been consistently unsuccessful and unprofitable (both in issuer earnings and first day returns), underwriters and, in particular, analysts associated with unaffiliated broker-dealers do not want to waste resources or become involved with unpromising transactions.

Congress should also be mindful of some limits on its power. There could even be a First Amendment limitation on any attempt by Congress to mandate that

underwrites (or particularly unaffiliated brokers and analysts) publish research studies on impending IPOs.

To be sure, there are ways that Congress could seek to subsidize such research (possibly by asking exchanges, as other nations do, to bear some of the costs of such research and pass the cost onto all brokers and dealers on that exchange). But such a proposal (which has been adopted in other countries) is too complicated to discuss in this testimony.

7. H.R. (removing the prohibition on large accelerated filers qualifying as EGCs).

This is essentially “Enhancement Four” in “Expanding the On-Ramp’s” proposed “Enhancements to the JOBS Act” (see p. 12). From my humble perspective, there is a basic contradiction here: you are hardly an “Emerging Growth Company” if you are also a “Large Accelerated Filer.” Conceptually, it is hard to be both small and large at the same time.

More importantly, this proposal exempts large companies (namely, large accelerated filers) from the disclosure requirements applicable to most issuers. This is a far cry from a temporary bridge for EGCs, but rather concludes that, to induce IPOs, Congress should let the big issuer remain exempt. It is highly unlikely that this strategy will work, because this incentive has not induced many IPOs in the years since 2012. But even if it did work (to some degree), it institutionalizes a two-tier disclosure system, based not on size, or public float of the issuer, but on when the issuer went public.

Ultimately, eliminating the “phase out” rules (such as the “large accelerated filer” condition) does not encourage new IPOs (because the recipients of this

exemption have already “gone public” years ago). No doubt, some public companies would like to remain EGCs, but that creates a permanent two-tier market, not a transitional bridge.

8. H.R. \_\_\_\_\_ (to provide a five year extension for EGCs)

This is “Enhancement One” to the “Expanding the On-Ramp’s” “Enhancements to the JOBS Act” (at p.10). The core idea to the JOBS Act was to create a five-year bridge for EGCs to transition to full “reporting company” status. EGCs are now lobbying to make this bridge permanent. If they get their additional five year extension, there can be little doubt that these same EGCs will seek another exemption in five more years (and may succeed in recreating a permanent exemption, regardless of their size, earnings, or public float).

The result is likely to be a permanent two-tier disclosure system in which EGCs never are required to make the same disclosures as those companies that went public before 2012 (the date of the JOBS Act). The only rationale for such a bizarre system is that it might conceivably cause firms to “go public” that otherwise would not. But the evidence to date does not suggest that JOBS Act has provided any strong incentive. To be sure, high-tech “unicorns” do go public (as Dropbox exemplified this year), but they want until it is possible to obtain an IPO valuation well in excess of their prior valuation in this private equity market (and many “unicorns” cannot obtain such a valuation and so remain on the sidelines). Other private companies may follow Spotify and do a “direct listing”. But smaller companies will not have this opportunity and will turn instead to the M&A market where they receive much higher valuations. Unfortunately, the JOBS Act’s cost-saving subsidy thus goes to high-tech offerings

(which need no such subsidy) and does not motivate smaller companies (because such offerings are unprofitable).

9. H.R. (replacing Form 10-Q with a press release)

This is “Improvement Three” in the “Expanding the On-Ramp” proposals.

It would grant EGCs the option of replacing Form 10-Q with a press release. This is one of the worst ideas in this package, because over time it would undercut our quarterly reporting system. If EGCs receive a ten year exemption from most quarterly disclosures, this will create predictable political pressure for further time extensions and eventually a permanent exemption. Eventually, those older companies still subject to quarterly disclosure will lobby for corresponding exemptions.

Substituting a press release for a Form 10-Q is not a small change. A press release need only disclose revenues and earnings (if that), and need not provide full financial statements. Today, the Form 10-Q contains important forward-looking information in its “MD&A” section, and this information will likely no longer reach investors in the exempted companies. This retreat from full disclosure and transparency is substantial (even if it is here masked as a minor change).

Although investors would thus lose much transparency, there is no real evidence that this incentive will produce any significant increase in IPOs (and little evidence suggests that this has happened since 2012). Nor is there evidence that inducing successful companies in the private markets to list in the public markets produces significant gains for the economy. Further, the many “unicorns” now waiting on the sidelines in the private markets are not waiting to realize minor cost savings in going

public. Rather, they are largely waiting for the optimal moment when they can obtain a valuation well in excess of the already high valuation they enjoy in the private market.

10. H.R. (to allow purchases of EGC shares to be qualifying investments for purposes of the Registered Investment Advisor exemption)

This is “Improvement Five” to the “Expanding the On-Ramp” proposals (see p.21) Once again, this is a legislative edict that would amend SEC rules (here Rule 203(1)-I under the Investment Advisors Act), and the views of the SEC have not yet been requested (or at least made public).

The impact of this proposal would likely be modest (and I do not suggest that it is necessarily undesirable), but it would be preferable to place the horse before the cart and ask the SEC if it is willing to amend its rules (or explain why not) before repealing these rules.

11. H.R. (to increase mutual fund diversified limits from ten percent to fifteen percent)

This is “Improvement Ten” to the “Expanding the On-Ramp Proposals” (See p.24). It may well be a sensible proposal, but the SEC’s views on it have not been made public. I tend to doubt that many mutual funds will be willing to hold 15% stakes (as opposed to 10% stakes) in a portfolio company, because, once over 10%, they are generally subject to Section 16(b)’s “short-swing” profit recapture provisions (and they also are likely to encounter greater liquidity problems in selling such a large stake). But the idea is plausible.

Conclusion

This package of bills proposes major retreats in disclosure and corporate governance in order to encourage some additional IPOs. The evidence to date does not show any significant response to the larger concessions made in the JOBS Act in 2012. Moreover, these proposals may turn a transitional bridge into a permanently two-tier disclosure system.

Not all these proposals are necessarily wrong-headed, but they have not been vetted adequately by the SEC or other concerned constituencies. Some -- most notably, the modifications to the shareholder proposal rule (Rule 14a-8), the say-on-pay rules, and the generally hostile attitude toward proxy advisory firms -- represent major retreats in corporate governance. Other proposals -- most notably, the substitution of a press release for a Form 10-Q -- significantly reduce transparency and would predictably encourage other issuers to demand parallel exemptions.

The costs seem real, while the benefits may be illusory. There is no crisis demanding major deregulation. Although smaller IPOs will continue to decline, the much larger “unicorns” are simply biding their time. Eventually, they will go public, but small cost incentives will not motivate them.

If these bills pass, one prediction is safe: in five more years, we will see JOBS Act III, based on the same dubious assumptions.

**Statement of Barry Eggers  
 Partner, Lightspeed Venture Partners  
 Board Member, National Venture Capital Association  
 before the Subcommittee on Capital Markets, Securities, and Investment  
 "Legislative Proposals to Help Fuel Capital and Growth on Main Street"**

May 23, 2018

Chairman Huizenga and Ranking Member Maloney, thank you for the opportunity to testify today on the important subject of capital markets reform and encouraging more U.S. public companies. My name is Barry Eggers, and I am a Founding Partner at Lightspeed Venture Partners, a venture capital (VC) firm that invests in, and works closely with, cutting-edge technology startups in areas such as information technology, data analytics, cloud computing, storage, networking, ecommerce and consumer marketplaces. I am here in my capacity as a board member of the National Venture Capital Association.

Let me begin by explaining why venture capitalists care about policy issues pertaining to our public capital markets. There are three main ways that venture capitalists exit an investment: 1) a merger/acquisition 2) an initial public offering (IPO) or 3) a business failure. While the vast majority of venture capital investments are in private emerging growth companies (EGCs), recent research has shown that nearly half of all companies that have gone public since 1979 have been backed by venture capital<sup>1</sup>. We sit on the boards and provide advice and counsel to many of the companies who consider going public. Generally once they go public they exit the VC ecosystem. But the ability and attractiveness of becoming a public company is a critical issue for the growth of our portfolio companies while we are involved with them.

To provide a little background on venture capital, we are investors in the nation's startups. At Lightspeed for instance, we invest early in a company's life, often when there are a few founders trying to build out a new concept. We work with these entrepreneurs to grow the company into a successful enterprise, including providing mentorship and strategic advice, helping them hire new employees, introducing them to potential customers, and providing additional rounds of financing to fuel continued growth. This work typically takes a lot of patience over a long time horizon. At Lightspeed, the average time to IPO from first investment is roughly eight years.

I've been a venture capitalist for over two decades, and in the technology ecosystem for over 30 years. I have witnessed firsthand the increasing willingness among founders and CEOs of private EGCs to sell their companies instead of taking them public. When I first got started in the business, the goal of most entrepreneurs was an IPO, and many companies were successful in that endeavor – such as Maker Communications, a company I invested in that went public in 1999. Maker had quarterly revenue of \$3 million prior to their IPO. They had raised \$24 million from venture capital firms and then raised \$44 million in their IPO, which valued them at \$230 million. Twenty years later, an IPO is rarely a goal for an EGC. Many view the public markets as hostile to innovative small-capitalization companies and would rather have the certainty of a trade sale than deal with the challenges, complexities, and costs of running a public company. And for those that do go public, they often do so only when they've grown to a size that can

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<sup>1</sup> <https://www.gsb.stanford.edu/insights/how-much-does-venture-capital-drive-us-economy>

better bear the burdens that come with being public – such as Nimble Storage, another company I invested in which went public in December 2013 – and is representative of the first batch of EGCs to go public under the 2012 Jobs Act. Nimble had quarterly revenue of \$33 million prior to their IPO. They had raised around \$100 million in venture capital and raised \$168 million in their IPO, which valued them at \$1.5 billion.

The data here is rather stark. Since 2000, the U.S. is averaging less than half the number of IPOs per year than in either the 1980s or 1990s<sup>2</sup>. A consequence is that the U.S. now has about half the number of public companies than twenty years ago<sup>3</sup>. My firm, Lightspeed, has one of the strongest track records of IPOs since 2016. We have had seven portfolio companies go public over the last two and a half years. But that is still less than 5 percent of the 145 active companies in our portfolio.

#### **Challenges Facing EGCs**

Avoiding the public markets has unfortunately become a prevalent view among many EGC executives. It is a far less attractive proposition to run a public company now, and as a result, many choose to forego this option altogether. As an example, AppDynamics, previously a Lightspeed portfolio company, faced this choice and decided to sell rather than become public. At the time, AppDynamics was a growing company that had actually gone through all the work to prepare for an IPO and had successfully completed their IPO roadshow. The day before they were scheduled to go public, they decided instead to sell to Cisco Systems. Mergers and acquisitions are certainly a healthy economic activity, but my point with AppDynamics was that even a healthy company with a bright future can look at the public markets these days and decide it is not worth the uncertainty. As a result, there is one less independent, high growth public company which creates jobs and becomes an acquirer of small companies.

The myriad issues that discourage EGCs from going public can be grouped into three broad categories: 1) the increased cost and complexity of running a public company 2) the collapse of market making infrastructure, including research coverage for EGCs and 3) the challenges presented by a culture of short-termism. In each category, since the turn of the millennium, policy changes and industry trends have conspired to increase the challenges facing small public companies. For example:

- Sarbanes-Oxley significantly increased the costs of operating a public company;
- The Global Settlement in 2003 disrupted the economics of research coverage for smaller companies;
- The rise of activist investors and manipulative shorting have made it more difficult for innovative companies to access capital in the public markets for longer-term projects.

Many of the policy changes were well intentioned attempts to solve for separate policy issues. Similarly, industry trends may have good intentions at their core, perhaps seeking to impose discipline on public companies or force more accountability to shareholders, for instance. Unfortunately, time and again the EGC IPO ecosystem becomes collateral damage to these

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<sup>2</sup> *Initial Public Offerings: Updated Statistics*. Jay Ritter, University of Florida, March 8, 2016

<sup>3</sup> Jay Ritter, University of Florida, Number of Listed Firms in the U.S. 1980-2015, by quarter.

objectives. And as these challenges continued to pile up, they have made the decision to go public harder for entrepreneurs to justify.

#### **Consequences of Fewer Companies**

I believe there are two significant consequences arising from the lack of IPOs and the decline in U.S. public companies: a decline in job creation and a loss of investment opportunities for retail investors. Every time a company chooses to sell itself rather than go public, there is a negative impact on the U.S. jobs market in terms of reduced potential new job creation and often there are job reductions once the companies fully merge. Research indicates that 92 percent of job creation happens at companies once they go public<sup>4</sup>. And data provided by Professor Jay Ritter, a professor at the University of Florida who has been a prominent voice on the IPO market, posits that this lack of IPOs has cost the economy on average about two million new jobs a year. From what I have seen, many of these jobs can be the type that support middle class families and don't necessarily require college degrees. I am thinking for instance about human resources or administration jobs, which often disappear after a merger.

The lack of IPOs has also had an impact on middle class retirement savings and retail investor portfolios. To provide a few examples of the growth in value of venture-backed companies if one bought into their IPO, Microsoft which went public at a \$350 million dollar market capitalization is now worth more than \$500 billion. Genentech raised \$35 million in their revolutionary 1980 IPO and was acquired at a valuation of \$106 billion in 2009. Amazon's market capitalization has increased by a factor of 1,100 from their \$440 million market capitalization at IPO. Yes, IPOs are risky to invest in, but they have also provided a fantastic opportunity for wealth creation to main street investors.

#### **Jumpstart Our Business Startups (JOBS) Act**

The JOBS Act was a terrific start to tackling this difficult challenge. And I have seen it used first hand. In particular, the provisions allowing for EGCs to file with the SEC and to test the waters with prospective investors confidentially have made it easier to go public without harming investor protection. And in my view, the creation of the Emerging Growth Company construct was one of the most creative pro-growth policies in recent memory. EGC status allows companies that are under \$1 billion in annual revenues and who are either private or public for less than five years to access a scaled disclosure and regulatory regime.

#### **Expanding the On-Ramp**

The joint report endorsed by NVCA, *Expanding the On-Ramp*, offers a blueprint for building off the success of the JOBS act and making it more attractive to be a public company. One aspect that struck me was the breadth of viewpoints that were brought to bear in the coalition which came together to compile this report. From company operators to those whose job it is to facilitate public offerings, exchanges, and investors such as myself, the report leans on the experience of industry participants who have seen this challenge from a broad cross-section of perspectives. While I may not be an expert on market structure, I do understand how challenges with liquidity can impact the decision of one of my portfolio company CEO's decision to take their company public. This is a complex and multi-faceted challenge, and so needs a comprehensive effort.

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<sup>4</sup> [https://www.sec.gov/info/smallbus/acsec/rebuilding\\_the\\_ipo\\_on-ramp.pdf](https://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf)

In particular, I view the enhancements to EGC status as a positive move to improve the experience for companies going into the public markets. Removing the phaseout of EGC status for large accelerated filers will provide more certainty for companies that the benefits of EGC status will be there unless they cross a more predictable revenue or time threshold. The problem that the current large accelerated filer phaseout presents is that the definition is based on public float, which is a function of stock price and can be quite variable. For instance, looking at the history of the companies that Lightspeed has been involved with which went public since 2016, there was an average difference of about 68 percent between the high price and the low price in the first six months of trading post-IPO. And even if the company crosses the \$700 million public float threshold for one day, they lose EGC status permanently. As a result, this company would then be responsible for an audit of internal financial controls immediately, an expensive surprise indeed and one that can call into question the certainty of EGC benefits.

I applaud the Committee for your work on allowing any investment into an EGC to be considered a qualifying investment for purposes of the VC exemption definition from the Registered Investment Advisor (RIA) regulatory regime. Congress created both the EGC definition and the VC exemption for similar purposes, namely a favorable capital formation regulatory environment for growing companies. That secondary share purchases of EGCs are currently non-qualifying is becoming an increasing challenge for VC funds that are forced to choose between continuing to follow their companies along the growth trajectory and risk the significant expense and difficulty of registration or passing on further capital formation opportunities for certain portfolio companies. Neither outcome is positive.

I understand that rebuilding the research coverage and market making infrastructure is a difficult undertaking, but it's absolutely critical to solving this challenge. And so a study of pre-IPO research coverage seems to be a good place to start. I hope this work can be done expeditiously so we can begin to implement policy reforms that will encourage the research coverage EGCs desperately need to have success going public.

### **Conclusion**

I am excited to see the Congress take such a deep and thoughtful look at an issue that is fundamental to our country's future. As a venture capitalist, I have spent my career building the next generation of America's companies. I believe that if we can encourage more of these companies to go public in the next decade, we will improve access to economic opportunity in the country, as well as our economic competitiveness.

Again, thank you for providing me the opportunity to testify today on this critical topic. I'm happy to answer any questions.

**Testimony of Tyler Gellasch, Executive Director of the Healthy Markets Association**

**Hearing on Legislative Proposals to Help Fuel Capital and Growth on Main Street  
Before the House Financial Services Committee, Subcommittee on Capital  
Markets, Securities and Investment**

May 23, 2018

Chairman Huizenga, Ranking Member Maloney, and other members of the Subcommittee, thank you for holding this hearing, and for offering me the opportunity to appear before you today.

I am the Executive Director of the Healthy Markets Association. Healthy Markets is an investor-focused, not-for-profit coalition.<sup>1</sup> Our members, who range from a few billion to hundreds of billions of dollars in assets under management, have come together behind one basic principle: Informed investors and policymakers are essential for healthy capital markets.

Today, this subcommittee is examining a number of proposals that many argue would promote small businesses' access to the capital markets. The majority of these proposals are, predictably, being pressed by companies, their executives, and their service providers. That makes sense. These groups have a clear interest in maintaining and expanding their access to capital.

However, these proposals also largely ignore the other side of the markets: the investors. Investors are of course an essential party in capital formation as well as any exit strategy for those who have provided venture funding to a private company: if a company, its executives, or its early investors want to sell their securities, they need investors who will purchase their securities. Without investors, there is no capital formation (or liquidity event).

This might be part of the reason why prior issuer-driven capital formation proposals have not fulfilled their proponents' expectations. For example, the high-profile JOBS Act doesn't seem to have made any dent on the steady decline in the number of public companies. From a peak of around 7500 public companies about two-decades ago, we're now just above 4000. Since the passage of the JOBS Act, the number of public companies has continued to go down. As discussed in detail below, there may be many

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<sup>1</sup> Launched in 2015 by five leading buy-side firms, Healthy Markets has since expanded to include sixteen buy-side and working group members and partners, including leading pension funds, investment advisers, broker dealers, data providers, and an exchange. For more information about our membership, please see our website, [healthymarkets.org](http://healthymarkets.org).

reasons for that, including consolidation fueled by a low-interest rate environment and regulatory and cost advantages for larger firms.

Further It appears that the JOBS Act had no measurable impact on the number of IPOs. In the four years from 2014-2017, there were only 503 IPOs, despite a massive broad stock market rise during the period.<sup>2</sup> By way of contrast, in the four years from 2004-2007, there were 646 IPOs.

This is not surprising to many investors and observers, as so much of the JOBS Act was devoted to expanding opportunities for companies to remain private.<sup>3</sup>

The current level of IPOs could also be a function of the fact that IPOs have significantly underperformed mature firms in the first year after going public.<sup>4</sup> Put simply, IPOs may be down because investors may be factoring in their relatively poor performance versus the rest of the market.

Further, the JOBS Act's efforts to promote lower-cost "mini-IPOs" with a lighter regulatory regime have similarly led to poor performance for investors. According to Barron's

Investors so far have little to show for the hundreds of millions of dollars that the U.S. Securities and Exchange Commission says have gone into these IPOs since Reg A+ took effect in 2015. Investment returns are hard to find, mainly because only a few dozen of the 300-odd Reg A+ stocks have gotten so far as to list on the NYSE, NASDAQ, or OTC markets, where you can trade or at least get a price quote. Those include a handful of community banks and one outfit carried high on the recent blockchain froth. Excepting those, the average Reg A+ stock fell 40% in the six months

<sup>2</sup> Jay R. Ritter, *Initial Public Offerings: Updated Statistics*, Jan. 17, 2018, available at [https://site.warrington.ufl.edu/ritter/files/2018/01/IPOs2017Statistics\\_January17\\_2018.pdf](https://site.warrington.ufl.edu/ritter/files/2018/01/IPOs2017Statistics_January17_2018.pdf).

<sup>3</sup> For example, the JOBS Act removed restrictions on "general solicitation" for private offerings and also raised the shareholders of record thresholds for when a company would be compelled to become a public filer. Both of these efforts expand the relative size of the private – not public – markets. In fact, while on the Senate staff, I argued that the greatest likely impact of the JOBS Act would be the dramatic growth of the private markets—likely at the expense of the public ones.

<sup>4</sup> Daniel Hoechle, Larissa M. Karthaus, and Markus Schmid, *The Long-Term Performance of IPOs, Revisited*, (Feb. 2018), available at <https://poseidon01.ssrn.com/delivery.php?ID=42902210602112612608311212607100112011603407003500505097071030030066093066073001077124004061061006108028027117118125079097025008087047000081003016112115126126006081077040020099110090124072126123100097081112069001066098074092113123085067090006085099&EXT=pdf> (finding that for 7,487 IPOs between 1975 and 2015, the one year performance was significantly worse than for mature firms).

after its mini-IPO and has underperformed the raging bull market surrounding them by nearly 50 percentage points.<sup>5</sup>

Even worse, the one blockchain-related outlier detailed in the Barron's study, Longfin, subsequently had its assets frozen in an emergency fraud enforcement lawsuit by the SEC less than 6 months after its mini-IPO.<sup>6</sup>

Some business failures are inevitable amongst any group of early-stage startups, but this record demonstrates that these efforts are not helping investors or the economy. While this could be viewed as "capital formation," I think we can all agree that these are not the types of outcomes policymakers, regulators, or really anyone should want.

Simply reducing disclosures, or further expanding the potential use of exempt offerings isn't likely to increase the appetite of investors or spur capital formation--at least in any economically beneficial way. That approach has been tried--repeatedly--and failed.

We recommend you consider a different approach.

Rather than focusing solely on what the would-be sellers and their service providers believe might help them, we urge you to consider equally the expectations and needs of investors. If you include investors' perspectives, you will likely come to some very different conclusions as to why we have fewer public companies and will likely come up with markedly different ways to address that problem.

To be clear, the relative costs and burdens of being a public company are markedly greater than they were years ago. Further, despite decades of "innovation" and technological developments, the costs of actually "going public" -- particularly for smaller companies, may be significant. Some of these burdens and costs are imposed by regulatory demands. Some are imposed by investors.<sup>7</sup> And still others -- perhaps some of the greatest -- are imposed by those who would be retained by companies to assist them in raising capital.<sup>8</sup>

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<sup>5</sup> Bill Alpert, Brett Arends, and Ben Walsh, *Most Mini-IPOs Fail the Market Test*, Barrons, Feb. 13, 2018, available at <https://www.barrons.com/articles/most-mini-ipos-fail-the-market-test-1518526753>.

<sup>6</sup> Complaint, SEC v. Longfin Corp. et. al., 18 Civ. 2977, Apr. 4, 2018 (S.D.N.Y.), available at <https://www.sec.gov/litigation/complaints/2018/comp-pr2018-61.pdf>.

<sup>7</sup> One of the most significant sets of challenges for companies may be overcoming skeptical investors, who have seen significant underperformance by IPOs for decades. Hochle et al.

<sup>8</sup> See, e.g., Robert J. Jackson, Jr., *The Middle-Market IPO Tax, Remarks Before the Greater Cleveland Middle Market Forum*, April 25, 2018, available at <https://www.sec.gov/news/speech/jackson-middle-market-ipo-tax> (suggesting that underwriters impose an effective "seven percent tax" on middle market companies who go public).

We encourage you to think about both the costs and burdens on would-be sellers, but also the impacts on would-be purchasers. We also encourage you to consider ways to enhance the public markets directly--not just by thinking about IPOs.

In the pages that follow, we explore:

- what institutional investors like pension funds generally want;
- why the public markets are so important to institutional investors;
- the decrease in the number of public companies; and
- why past efforts to improve the public markets have failed, and why many of the current proposals will likely suffer a similar fate.

Lastly, we offer three recommendations.

First, we recommend that you support research in small companies by removing a market-distorting subsidy that disadvantages smaller and independent research providers, which are the primary providers of research in smaller companies. While we take no position as to whether asset owners or their investment advisers should ultimately pay for investment research, as we detail below, it is essential that investment advisers be able to separately shop and pay for trade executions and research. Unfortunately, that is not the situation that prevails today in the United States.

The bundling of research and execution leads to consolidation of research and trading with the largest broker-dealers. Such consolidation has a number of negative consequences, including that it increases costs for investors, and also competitively disadvantages the smaller, independent research providers versus their larger peers. We encourage you to unleash competition for the provision of research.

Second, over the longer term, we encourage this Subcommittee to consider reviewing, with an eye towards reducing exemptions from the public offering and publicly reporting company rules imposed by the Securities and Exchange Acts. Put simply, these exemptions and exceptions have expanded the private markets dramatically in the past few decades, and much of that growth has come at the expense of the public markets. As a general matter, we should stop diverting investors and companies away from the public markets.

Third, we urge you to think about rules that promote industry consolidation. One of the most notable developments over the past several years has been the comparative costs of capital between firms. While some of the contributors to this disparity are monetary policy and competitive pressures, other factors are simply a function of SEC Rules. For years, and particularly since the SEC's adoption of the Well-Known Seasoned Issuer

reforms in 2005, SEC Rules have intentionally made it easier for big companies to raise capital than smaller ones.

Some would argue that we should simply lower the bar for all public offerings. We disagree. Simply because a large corporate issuer is familiar with the regulators doesn't mean that the securities they offer are not risky, and the offering documents don't deserve all due scrutiny by the SEC staff and investors. We would encourage you to avoid the regulatory "race to the bottom," while also reducing or eliminating the regulatory discrepancy that systematically advantages larger firms over smaller ones.

## What Do Investors Generally Want?

If you ask large pension funds, for example, they will tell you that they generally want more public securities, not fewer. Expanding exemptions from registration, such as by expanding the number of would-be purchasers or easing Rule 506, would likely divert capital away from the public markets, rather than to them. Similarly, expanding the ease of trading of private securities (such as through venture exchanges), would also likely divert capital away from the public markets.

Investors generally want more, higher quality, and more readily accessible information about companies. At a minimum, removing information from investors, making information harder to analyze, or making information less reliable will likely lead to a higher--not lower--cost of capital, as investors will expect to be compensated for taking on greater risks. These actions could also likely make investors want to invest less, or not at all.

Investors generally want shareholder rights. They are buying ownership in a company. They want to make sure that if the company commits fraud, they can have meaningful recourse. Investors want to make sure the company is incentivized to fully and completely comply with the law. And while the vast majority of investors do not typically want to actively shape corporate activities, many do. That is how capitalism works.

Investors want to be able to trade their securities. While most investors are not the rapid-fire traders that seem to dominate the news, even the most patient investors want to have liquidity. This is particularly important for trading in small cap stocks, where information is typically low, and trading costs are typically quite high.

## Why Are Public Capital Markets So Important for Investors?

This Committee has considered a number of legislative proposals to improve “capital formation.” At the same time, the Treasury Department,<sup>9</sup> SEC Chairman,<sup>10</sup> and SEC Commissioners of both major political parties<sup>11</sup> have argued that improving the public capital markets should be a high priority. We agree.

There’s good reason to focus on restoring the dominance of the public markets. When compared to private securities, public securities typically offer a number of significant advantages for investors, including:

- Public securities often are accompanied by more robust accounting and business disclosure practices.
- Information about public companies, including third party research, is much more readily available and fairly distributed (as required by SEC rules).
- Public securities are far more easily and reliably valued.
- Public securities offer a transparent and efficient method to liquidate shares of common stock.
- Liquidity risks and trading costs for public securities are often significantly lower than for similarly-situated private securities.
- Public securities are much more easily benchmarked, such as against the S&P 500.

These factors play a paramount role in pension plans’ and investment advisers’ abilities to fulfill their respective fiduciary duties. They are obligated to mitigate risks and costs for their beneficiaries.

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<sup>9</sup> See generally, Treasury Capital Markets Report.

<sup>10</sup> Jay Clayton, Nomination Hearing for Jay Clayton Before the Senate Committee on Banking, Housing and Urban Affairs, 115th Cong. (2017), available at <https://www.banking.senate.gov/imo/media/doc/Clayton%20Testimony%203-23-17.pdf>. In fact, in Clayton’s written testimony, he includes only one footnote, which is to articles highlighting concerns with the dwindling numbers of public companies. *Id.*, at 2, n.1.

<sup>11</sup> See, e.g., Robert J. Jackson, Jr., *The Middle-Market IPO Tax, Remarks Before the Greater Cleveland Middle Market Forum*, April 25, 2018, available at <https://www.sec.gov/news/speech/jackson-middle-market-ipo-tax>; see also, Hester M. Peirce, *Tossing Fish and Catching Capital, Remarks at the 38th Annual Northwest Securities Institute CLE at the Washington State Bar Association*, May 4, 2018, available at <https://www.sec.gov/news/speech/speech-peirce-050418>.

These investors are acutely aware that, as we go down in company size, disclosure quality, and trading liquidity spectrums, the general utility for institutional investors (and likely risk/reward proposition) deteriorates quickly.<sup>12</sup>

One major difference between public and private markets is trading cost. As we speak, the SEC is considering taking unprecedented actions to evaluate how order routing incentives that are fractions of a penny per share may be costing investors' returns in trades involving NMS stocks.<sup>13</sup>

So-called "effective spreads" in the largest companies are less than a penny per share. For less-liquid public companies, these spreads may be pennies per share. By the time you get to the OTC markets, these trading costs may be quite large. And by the time you get to private securities, trading costs may total many, many times those of trades in public securities.

These trading costs likely come out of the funds' returns. This money doesn't go to a retirement fund for the investor or the company, but to the trading firm. It is nothing more than a tax on investors. If the markets exist to serve the companies driving the economy forward, and the investors who give them the capital to do it, the intermediary is the least of our concerns. But they are some of the big winners in this decades-long shift from public to private markets.

In fact, because of the significantly greater risks and costs associated with private securities, many pension plans have investment restrictions on the percentages or dollars of their portfolios that may be appropriately dedicated to these offerings.<sup>14</sup> Issues like "size, liquidity, and cost efficiency" are frequently used by institutional investors and their fiduciaries to determine whether and how much they may invest in a given asset class--such as private equity securities.<sup>15</sup>

Similarly, investment companies or other investment vehicles are often benchmarked to indices that do not include private offerings. As a result, few investment companies and

<sup>12</sup> See, e.g., Joshua T. White, SEC, *Outcomes of Investing in OTC Stock*, Dec. 16, 2016, available at [https://www.sec.gov/files/White\\_OutcomesOTCinvesting.pdf](https://www.sec.gov/files/White_OutcomesOTCinvesting.pdf) (finding that "[a]nalysis of 1.8 million trades by over 200,000 individual investors confirms that the typical OTC investment return is severely negative. Investor outcomes worsen for OTC stocks that experience a promotional campaign or have weaker disclosure-related eligibility requirements.").

<sup>13</sup> *Transaction Fee Pilot for NMS Stocks*, SEC, 83 Fed. Reg. 13008 (Mar. 26, 2018), available at <https://www.gpo.gov/fdsys/pkg/FR-2018-03-26/pdf/2018-05545.pdf>.

<sup>14</sup> Perhaps not surprisingly, the majority of owners in OTC equities are so-called "retail" investors--not retirement plans or other "institutional" investors. FINRA, *Unraveling the Mystery of Over-the-Counter Trading*, Jan. 4, 2016, available at <https://www.finra.org/investors/unraveling-mystery-over-counter-trading>.

<sup>15</sup> See, e.g., California Public Employees' Retirement System, *Total Fund Investment Policy*, at 7, (effective Nov. 13, 2017), available at <https://www.calpers.ca.gov/docs/total-fund-investment-policy.pdf>.

other public investing vehicles invest in private securities, or if they do, only do so to a very limited extent, and usually at very late stages (i.e., shortly before an anticipated public offering or acquisition).

Put simply, shifting capital from public to private markets:

- Increases risks for investors;
- Increases costs for investors; and
- Decreases opportunities for investors.

### The Decrease in the Number of Public Companies

It's not a great mystery why in the last few years the trend has developed whereby there are more private offerings in the US today than public ones. In the past, the law and SEC rules simply didn't permit all these private offerings.<sup>16</sup> Over the past two decades, however, Congress and the SEC have spent years constructing ad hoc exemptions and exceptions designed to allow firms, their executives, and their early investors to sell securities without incurring the costs or burdens typically associated with public offerings. While some of these exemptions and exceptions may have been well-intended, the undeniable result has been that they have grown so dramatically that they have undermined the public markets.

For decades, corporate issuers, lawmakers, regulators, market participants, and others have struggled with finding the appropriate regulatory balance to ensure that (1) companies are able to raise the capital they need to survive and grow, and (2) investors are able to have a fair understanding of the reasonable risks and returns of the securities they buy.

For most of this period, the concerns have largely focused on the burdens facing corporate issuers of securities. These arguments were well-articulated long before the Enron and Worldcom accounting scandals gave rise to the adoption of Sarbanes-Oxley Act. In fact, both before and after the passage of SOX, these arguments gave rise to an array of largely disconnected, discrete exemptions from the registration, disclosure, and trading restrictions of the federal securities laws, including the creation of the controversial "accredited investor" definition and related exemptions, Rule 144A, and the "on-ramp" for so-called "emerging growth companies."

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<sup>16</sup> See, e.g., Elisabeth de Fontnay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 *Hastings Law Journal* 445-502 (2017), (tying the rise of private offerings to the easing of rules designed to increase their usage), available at [http://scholarship.law.duke.edu/faculty\\_scholarship/3741/](http://scholarship.law.duke.edu/faculty_scholarship/3741/).

In recent years, these same issues have given rise to new proposals, such as the creation of the so-called Regulation A+ and crowdfunding exemptions. Many of these efforts have recently received approval from this Committee or are being considered by it (e.g., expanding Regulation A+ or micro-offering exemptions).

Efforts to ease perceived burdens on corporate issuers have also led to the dramatic curtailment of securities litigation, embodied by the Private Securities Litigation Reform Act. These efforts continue to be advanced by recent proposals to preempt investors' ability to bring private enforcement actions in court.

Nevertheless, despite all of the past efforts, the relative number and dollar values of public offerings has diminished, as compared to private offerings (which now comprise over 50% of total offerings).

When focusing on the declining number of the public markets, many have pointed to the decrease in IPOs since the 1990s. But these comparisons in IPO numbers are also inappropriate for the simple reason that they use as the reference point an all-time high. Since 1980, there have only been more than 400 IPOs in three years (1996, 1997, and 1999),<sup>17</sup> the run-up before the dot com bubble collapse.

Do we really think it is a good idea to return to the days when a sock puppet can do an IPO, when that means investors could lose trillions in savings--again?

One thing is also very clear from the IPO data: financial crisis and scandal are terrible for IPOs. For example, the number of IPOs dropped precipitously in the wake of the bursting of the tech stock bubble and the widespread accounting scandals that followed. We had just 79 IPOs in 2001, 66 in 2002, and 63 in 2003.<sup>18</sup> Those dismal IPO numbers were long before the passage of Sarbanes-Oxley Act's provision requiring auditing of internal controls or the Dodd-Frank Act's requirement to disclose CEO pay ratios. In fact, after the passage of the Sarbanes-Oxley Act, the number of IPOs rebounded to about 162 per year for the next four years. But guess what happened in 2008 and 2009, as the world was gripped in the financial crisis? Just 21 IPOs occurred in 2008, and only 41 occurred in 2009.<sup>19</sup>

In short, the statistics make a pretty good case that the greatest way to promote IPOs is to stop financial crises. Affirmatively creating greater risks and costs for investors is unlikely to be an effective strategy for that.

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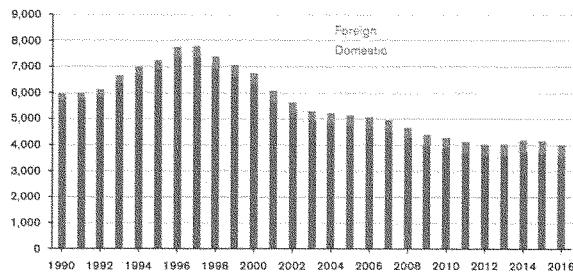
<sup>17</sup> Jay R. Ritter, *Initial Public Offerings: Updated Statistics*, (Jan. 17, 2018), available at [https://site.warrington.ufl.edu/ritter/files/2018/01/IPOs2017Statistics\\_January17\\_2018.pdf](https://site.warrington.ufl.edu/ritter/files/2018/01/IPOs2017Statistics_January17_2018.pdf).

<sup>18</sup> Ritter.

<sup>19</sup> Id.

It is also important to remember that while creating a robust IPO pipeline is important, it is not the ultimate objective for investors. Having more and better public companies is the goal for investors. Unfortunately, the number of public companies has fallen from over 7500, to barely 4000 in the past 20 years.<sup>20</sup>

Figure 1: Number of Public Companies in the United States, 1990-2016



Source: Securities and Exchange Commission staff analysis using data from the Center for Research in Securities Prices U.S. Stock and U.S. Index Databases(c) 2016 Center for Research in Securities Prices, The University of Chicago Booth School of Business.

The drop in the number of public companies has at least as much to do with delistings and mergers and acquisitions as it does with the declining number of IPOs. For example, as shown in Figure 1, which was included in the recent Treasury Department report, in the eight years from between 1996 and 2003, almost 2,800 public companies disappeared because of mergers, acquisitions, and delistings.<sup>21</sup>

The vast majority of the decrease in public companies occurred well-before the passage of the Sarbanes-Oxley Act (SOX) and the Dodd-Frank Act, and followed the curtailment of private securities litigation. So SOX didn't cause it, even with its required audits of internal controls. CEO pay ratio disclosures didn't cause it. And, on the other side of the coin, cutting investors' access to courts didn't stop it. Even more interestingly, the number of foreign public companies has remained steady, suggesting that while US-based companies are withdrawing from the US public markets, foreign issuers are still coming here.<sup>22</sup>

<sup>20</sup> U.S. Dep't of the Treasury, *A Financial System That Creates Economic Opportunities Capital Markets*, 21, (Oct. 2017), ("Treasury Capital Markets Report"), available at <https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf>.

<sup>21</sup> Treasury Capital Markets Report, at 21.

<sup>22</sup> Treasury Capital Markets Report, at 21. Notably, foreign investors are also still flocking to the U.S. at rates that dwarf any other country.

One potential contributor, that is often overlooked is that disparity in costs of capital between smaller and larger companies. It may be significant. Aside from the economies of scale that might exist regarding accounting, legal, and compliance costs, there is also a fundamental difference in relative costs of capital between firms of different sizes.

In particular, between a low-interest rate environment and rules specifically designed to their benefits (e.g., the Well-Known Seasoned Issuer status), the largest public companies have enjoyed extremely low relative costs of capital in the public markets. In fact, the largest public companies have, in recent years, tapped the capital markets repeatedly to have readily available capital with which to acquire smaller companies, or even engage in stock buybacks. Mixed with record corporate profits, stockpiles of "cash on hand" and low capital costs have been put to work by these large public companies in the form of acquiring smaller firms (which have higher costs of capital). This may have profound impacts on the number of public companies. Again, where a smaller company may have historically tapped the public capital markets itself, a larger firm can do that much more cheaply, and will likely provide a far more attractive option than an IPO to the smaller company's executives and early investors.

While many factors contribute to this disparate cost of capital, a key contributor is the disparate regulatory treatment between smaller firms looking to make a public offering, and those of larger firms. In particular, the Well-Known Seasoned Issuer rules, which were adopted in 2005, may help contribute to the disparity in raising capital for larger and smaller companies.<sup>23</sup>

In fact, that was the point. As the final rule adopting the reforms stated:

Today's rules will provide a class of well-known seasoned issuers greater flexibility in registering their securities offerings under a more streamlined registration process known as automatic shelf registration. Under the automatic shelf registration process, eligible well-known seasoned issuers can register, on a more flexible basis than is currently the case, offerings of different types of securities using Form S-3 or Form F-3 registration statements that are effective upon filing.<sup>24</sup>

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<sup>23</sup> *Securities Offering Reform*, SEC, 70 Fed. Reg. at 44726 (Aug. 3, 2005), available at <https://www.sec.gov/rules/final/33-8591fr.pdf>.

<sup>24</sup> 70 Fed. Reg., at 44726, n.40.

Put simply, the SEC decided to make public offerings quicker, easier, and less expensive for larger public companies, who they argued “tend to have a more regular dialogue with investors and market participants through the press and other media.”<sup>25</sup>

So-called Wksi status is frequently relied upon by larger companies. And the advantages may be significant for larger firms. Combined with the years-long low interest rate environment and other factors, it is entirely predictable that larger companies would raise capital often, and likely use it to acquire smaller companies; thus suppressing the number of public companies. And that seems to be what's been happening.

If we look at the overall public markets, a number of concerning trends appear:

- (1) Our public markets are increasingly concentrated on a decreasing number of corporate issuers;
- (2) Many high quality companies are staying private for very long into their corporate life-cycle, denying most mutual fund investors and pension funds the opportunities to invest without incurring significant (and often unprecedented) levels of risk and costs;
- (3) Companies that utilize the markets are typically bifurcated between (1) blank check companies and operational companies of dubious financial prospects<sup>26</sup> and (2) very large, established, multinational companies that may choose to list in the US market for a number of unique reasons;
- (4) A significant portion of IPOs are simply exits for early investors and executives, and not traditional “capital raises” for companies to survive and grow their businesses; and
- (5) A number of larger IPOs in the US have come with very limited investor rights, such as heavily diluted, or even no, voting rights.

Each of these trends comes with significant costs and risks for investors.

### Why Have Past Efforts to Spur Public Offerings Not Stemmed the Decline of the Public Markets?

Focusing on the absolute costs or burdens on public issuers will not solve the puzzle of increasing capital formation and restoring the health of the public markets. Rather, policymakers should evaluate the comparative cost of capital of public offerings versus

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<sup>25</sup> 70 Fed. Reg. at 44727.

<sup>26</sup> For example, a significant percentage of companies going public in recent years have been revenue negative or have disclosed notable accounting issues.

various forms of private offerings, not just in the US, but also abroad. If a company, its executives, and early investors can sell their securities to a practically unlimited number of investors using a satellite radio advertisement or Super Bowl halftime commercial, while not incurring basic accounting or corporate administrative costs, they will likely do so. This will be even more likely if traditional restrictions on trading of these "private" securities are loosened or repealed.

At the same time, policymakers also need to focus on the impacts of these various alternatives on investors--the providers of the essential capital. Simply continuing to deteriorate the value of their investment by providing less information, less tradability, and fewer rights is going to disincentivize investment in the US by domestic and foreign investors, not incentivize it.

While many of the proposals this subcommittee may be asked to consider could be characterized as "easing burdens" of those looking to sell securities, I encourage you to think of them from an investor's perspective. From the vantage point of an investor, the proposals:

- (1) Reduce the quantity, quality, and utility of information provided to investors (e.g., by repealing disclosures of various types, making disclosures by smaller companies harder to utilize (through exemptions from machine-readability), or by removing protections against conflicted research);
- (2) Increase the riskiness of a company's financials (e.g., by limiting the application Section 404(b) of SOX for newly public and smaller companies);
- (3) Increase the valuation risks of a company (e.g., by eliminating accounting and risk disclosures);
- (4) Increase the costs of trading the securities (e.g., by eliminating the application of Reg NMS to smaller companies' stocks); and
- (5) Decrease corporate accountability to shareholders (e.g., by restricting shareholder proposals, reducing access to proxy advisers, or by limiting shareholders' rights to litigation).

Importantly, not a single applicable study or any credible evidence exists to support how any of these changes individually or collectively would increase the number or dollars raised by IPOs. Nor would such a result reasonably follow. After all, the purported "beneficiary" of each of these proposals would be a potential corporate issuer, executives, and early investors looking to sell shares. But none of these factors is likely to overcome the already relatively low cost of selling private corporate debt or equity.

Rather than spurring additional IPOs, these efforts will divert companies and capital out of the public markets on the one hand, while also deteriorating the quality of public securities and the rights afforded shareholders on the other.

We want to distinguish those proposals, however, from efforts designed to encourage the physical and temporal aggregation of liquidity in small cap companies. In general, the current trading environment with penny-tick nominal spreads and fragmented markets has not made it easy for trading small cap stocks. The liquidity risks in small cap stocks are still much greater than their larger cap companies. Some have suggested efforts to improve this liquidity by attempting to aggregate trading, such as by consolidating trading on only one listing exchange (potentially achieved by permitting issuers to opt out of universal trading privileges), or by holding periodic batch auctions, or taking other methods.

Conceptually, we support efforts to aggregate liquidity for investors in these less-liquid securities. However, we must be careful to not replace one set of risks and costs with another. Universal trading privileges were permitted, in part, to combat market abuses and monopolistic pricing practices by exchanges.

Even with UTP, there is an example today where trading is aggregated at one exchange—and that is at the end of day auction. These closing auctions tell us to be very careful about forcing securities to trade at only one venue. Over just the past few years, as trading volumes have started to aggregate towards the close, the listing exchanges began to exploit their monopolies on closing auctions through higher fees. In response to the market outcry by investors and other trading firms, in January of this year, the SEC for the first time permitted a non-listing exchange to compete with a listing exchange's closing auction.<sup>27</sup>

Proposals to permit small cap companies to opt out of unlisted trading privileges could aggregate liquidity, but they will also create risks of monopolistic exchange behaviors (including pricing). If that occurs, the potential liquidity benefits of aggregating quotes and trading on a single venue may be quickly lost to the direct and indirect costs imposed by the exchange itself. Thus, if the Subcommittee or regulators were to significantly pursue this approach, we would urge you to carefully consider additional measures to guard against exchanges' potential exploitation of their newly-created monopolies.

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<sup>27</sup> *Notice of Filing of Amendment No. 1 and Order Granting Approval of a Proposed Rule Change, as Modified by Amendment No. 1, to Introduce Close Market Close, a Closing Match Process for Non-BZX Listed Securities under New Exchange Rule 11.28*, SEC, Rel. No. 34-82522 (Jan. 17, 2018), available at <https://www.sec.gov/rules/sro/batsbzx/2018/34-82522.pdf>.

## Recommendations for Improving Public Markets

The decline in the number of public companies, is an extremely complex issue, with multiple root causes. We do not think that any one solution will be a panacea for this problem. However, we do believe that there are at least two direct actions that this Subcommittee and regulators should consider, which we believe would help: (1) promoting research in smaller companies by removing distortions in how research providers are compensated, and (2) re-evaluating the proliferation of exemptions that allow for larger, more diverse, and more readily traded private markets—which often come at the expense of what would otherwise be public securities.

### Increase Research in Smaller Companies

We, like many, are concerned with the decline in research coverage for small cap companies. Research regarding small cap companies is essential to promoting investment in them. Investors—particularly investors in public securities—demand it. Research is definitely an area where more is better than less; indeed reforms from the JOBS Act of 2012 were driven by the belief that more research was needed in small cap companies.

Unfortunately, the predominant model for how research is delivered and paid for does not generally support research into small cap companies. Two of the most commonly discussed theories as to why small cap research has floundered are:

- 1) Research providers no longer make significant margins trading small cap stocks (including due to smaller trading tick sizes), and so they never invest the resources necessary to provide research coverage of those stocks; and
- 2) Investment advisers are no longer willing to pay enough for research into small cap companies.

Conceptually, both theories appear to have some validity. In fact, in response to the first theory, the SEC implemented the long-debated and ill-fated Tick Size Pilot.<sup>28</sup> Widening the trading increments, known tick sizes, didn't work. To date, there appears to have been no observable increase in trading profits for research providers, nor any increase in the provision of small cap research as a result of the Tick Size Pilot.

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<sup>28</sup> But see, David Weild, Edward Kim and Lisa Newport, *The trouble with small tick sizes: Larger tick sizes will bring back capital formation, jobs and investor confidence*, Sept. 2012, available at <https://www.sec.gov/info/smallbus/acsec/acsec-backgroundmaterials-090712-weild-article.pdf>.

As for the idea that investors simply are unwilling to pay for that research, there has not yet been any significant effort to address this theory. We urge you to consider it.<sup>29</sup> In fact, the concept of who pays how much for research generally is a key issue in the markets right now, largely as a result of changes demanded by European regulators and investors around the world.

Historically, investment research has been produced by brokers, consumed by investment advisers, and paid for by asset owners (out of their funds). At its most basic level, when an investment adviser would send an order to a broker, the broker would be paid a commission, a portion of which would serve as compensation for the execution, and a portion of which would serve as compensation for research. This practice is called “bundling.” The entire commission amount would come directly from the funds of the asset owners.

However, this practice introduces some significant risks for investors and conflicts of interest for investment advisers and brokers. As a practical matter, the parties providing and using the research are not themselves directly incentivized to constrain the costs. While US regulators have not directly examined the issue, a study by regulators in the United Kingdom found that

the majority of investment managers had inadequate controls and oversight when acquiring research good and services from brokers or other third parties in return for client dealing commissions ... [and] were unable to demonstrate ... how items of research ... were in the best interests of their customers.<sup>30</sup>

That said, bundling of research and execution costs creates distinct financial advantages for both investment advisers and brokers.

If an investment adviser bundles the costs, the customer most likely pays for the research, rather than the adviser. It may also relieve the adviser of some significant operational risk and cost concerns.<sup>31</sup> Similarly, if the research and execution costs are

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<sup>29</sup> We note that some have argued that consolidation of assets in larger asset managers has increased fund sizes, leading to concentrations in large cap stocks. That's because small cap stocks, which are also typically labor intensive to study and analyze, may not allow for investment sizes that are large enough to meaningfully impact the returns of a large portfolio. While this theory warrants consideration, we also note that even large investment advisers may utilize small, tailored funds to invest in small cap stocks.

<sup>30</sup> Financial Conduct Authority, *Changes to the use of dealing commission rules: feedback to CP13/17 and final rules (PS14/7)*, at 6, May 2014, available at <https://www.fca.org.uk/publication/policy/ps14-07.pdf>.

<sup>31</sup> However, driven by the implementation of MiFID II on January 3, 2018 and customer demands, many firms in the US and abroad are engaging in significant operational efforts and incurring significant costs to identify, value, and appropriately allocate the costs for research.

bundled, then the broker may benefit through the receipt of higher commissions than it would otherwise be able to charge independently for each, but it may also garner additional revenues from the order flow. This flow can be used to attract additional orders from other customers (garnering more commissions), but can also serve as a source of proprietary trading revenues.

These bundling benefits for investment advisers most directly benefit the largest brokers with both research and sophisticated trading services.

What happens when a broker has mediocre research, but excellent trading capabilities? What about if the broker has excellent research, but only mediocre or no trading capabilities? In these scenarios, investment advisers may be forced to choose between the research they want, and higher quality executions. This is unquestionably bad for investors. That is why, for more than two decades, many investors have advocated for the unbundling of research and execution costs.<sup>32</sup>

Worse, investment advisers are incentivized to utilize the bundled research provider in the example above, because the ultimate cost for the research is borne by their customers. As a pragmatic matter, that often means using a larger broker-dealer research provider, instead of a smaller research provider.

Worse still, even if an independent firm provides fantastic research, it may never be paid, or it may be paid at a significantly lower rate than if it was able to provide execution services. So these firms may be utilized less, and may be paid less, than large broker-dealer research providers.

As MiFID II's research payment rules have come into effect this year, some market participants (particularly large broker/research providers) have argued that unbundling the pricing and payments for research from trading will decrease the provisions of research into small and medium-sized companies. To be clear, we accept as fact that these rules will lead to less research being provided by many of the bulge-bracket research providers, and to a dramatic reduction in overall payments for research.

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<sup>32</sup> See Council of Institutional Investors, *Policies on Other Issues*, "Guiding Principles for Trading Practices, Commission Levels, Soft Dollars and Commission Recapture," (Adopted Mar. 31, 1998), available at [https://www.cii.org/policies\\_other\\_issues#support\\_db\\_plans](https://www.cii.org/policies_other_issues#support_db_plans); see also Letter from Jeffrey P. Mahoney, Council of Institutional Investors, to Jay Clayton, SEC, 2-3 (Sept. 22, 2017) (describing the benefits of unbundling research costs and trading), available at [https://www.cii.org/files/issues\\_and\\_advocacy/correspondence/2017/Sept %202022%202017%20SEC%20Letter%20\(final\).pdf](https://www.cii.org/files/issues_and_advocacy/correspondence/2017/Sept %202022%202017%20SEC%20Letter%20(final).pdf).

However, we argue that much of this research was waste and inefficiencies, and that it was also highly unlikely to be in small or mid cap stocks. Put another way, the overall spending on research is likely to go down because it was artificially inflated for years.

What is the relative value of the twenty-seventh research analyst on Apple stock? Do we, as a society, want to subsidize that analyst, at the expense of having a single analyst covering small cap stocks?

The curious argument that unbundling will lead to cuts in small cap stock coverage -- even though the primary beneficiaries of bundling don't actually provide much small cap stock research now -- appears to largely rest on the assumption that research costs in small and mid-cap stocks are being subsidized by trading revenues. Under this theory, if a firm is unable to also receive payments for executing trades, then it will no longer provide research.

In small cap stocks, this assumption seems unsupportable. In fact, it was a foundational premise in the creation of the Tick Size Pilot that trading revenues in small cap stocks are typically inadequate to support research costs for those stocks.<sup>33</sup>

But even further, in the United States, it is often the smaller, independent research firms that provide research for small cap companies. It generally isn't the larger broker-dealers who provide that research in these companies. The costs and margins are simply unattractive to most of the larger, bulge bracket brokers.

The smaller research providers are frequently paid in hard dollars by investment advisers (rather than through bundled commission), often because they lack adequate trading services or the trading volumes are inadequate to generate sufficient commissions to pay for the research.

Bundled commissions thus create a concrete conflict of interest that favors the largest broker-dealer research providers, stifles competition in research provision, and reduces diversity of research provision--particularly in smaller and mid-cap companies.

We urge you to consider directing the SEC to take actions to promote competition in investment research by encouraging and empowering investment advisers to separately shop for research and trading executions.<sup>34</sup> This would remove the discriminatory advantage of large broker-dealer research providers over smaller, independent research providers. Further, while we do not take a position on who ultimately should pay for investment research, the ability to separately shop and assign values for

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<sup>33</sup> See, e.g., Weild, et. al.

<sup>34</sup> We note that this could easily be achieved if all firms providing investment research simply registered as investment advisers.

research and trading is critical to reducing brokers' conflicts of interest and costs for investors.

### Review the Proliferation of Exemptions and Exceptions, and Consider Eliminating Many of Them

We recommend that this Subcommittee review, with an eye towards reducing, exemptions and exceptions from the Securities and Exchange Acts.

I grew up spending every weekend at our family farm. We had a big pond, which was essential to keeping the farm running smoothly. We spent a lot of time worrying about the water level of that pond.

I urge this Subcommittee to think of our public capital markets as a pond. To keep the pond full, you worry about the rain. But you also had to make sure the pond drains properly. The public markets are the same way. The water level is falling dangerously low. Sure, we've had more IPOs before. It's rained really hard before. But too much rain can also be a problem. I remember when a big storm came and washed out a wall of our pond--nearly draining the whole thing. The dot com bubble did that too. The massive rains of IPOs ultimately washed out a huge chunk of the markets--and many families' savings with it.

Today, the amount of rain filling up the pond is a little slow, but that's not my real concern: the water level is.

It does us no real good, even if the rain comes, if the water just drains out. We also need to make sure we're not draining the pond. And while it seems we've had a lot of discussion about the rain lately, we haven't mentioned the fact that since the federal securities laws were adopted, Congress and the SEC have dug many, many trenches leading away from the pond. And that seems to be as big--if not bigger--reason for the declining water level than the rate of IPOs raining into it.

Rule 506, Rule 144A, Crowdfunding, Reg A+, and so many more of the new exemptions and exceptions from the securities laws are all trenches. Raising the threshold for when a company has to be considered public is a trench. Expanding the ability to trade private securities--such as with venture exchanges--are more trenches. Expanding the pool of potential investors in private offerings even further is another trench.

Each of these features, while potentially making some offerings “easier”, comes with a cost. Companies and capital are flowing away from the regular public markets. This isn’t an unsolvable problem. It drains the pond. And in doing so, investors in these securities will have to suffer significantly greater valuation and market risks, liquidity risks, and fraud risks. Their trading costs will be higher, and their returns may be lower, than if those same companies were trading in the public sphere.

We urge you to consider reducing or eliminating many of the exemptions and exceptions that divert capital away from our public markets, resulting in raising risks and costs, while also draining opportunities, from investors.

### Reduce Unnecessary Regulatory Advantages for Large Firms

As we’ve said before, our primary concern is the health of the public capital markets. That is where the majority of retirees and parents saving for college put their money. And those public markets have been the cornerstone of our economy.

Aside from all of the ways to avoid the public markets, we also have a problem with aggregation, consolidation, and delistings. Over the last two decades, the number of public companies has been cut significantly, with the result that investors are increasingly concentrated in larger and larger companies.

One of the primary drivers of this has been the fact that capital for the largest firms is extremely easy to raise: in fact, it’s about as good as it has ever been. And there are many reasons for that, including federal interest rate policies and broader macro-economic trends. Many of those are not directly within this Subcommittee’s purview, or are challenging, if not impossible, to control.

But one significant contributor to the consolidation trend are where policymakers and regulators can control is the regulatory disparities between large and small firms. SEC Rules explicitly favor the largest firms. For years, and particularly since the SEC’s adoption of the Well-Known Seasoned Issuer reforms in 2005, SEC Rules have intentionally made it easier for big companies to raise capital than smaller ones.

We encourage you to reduce or eliminate that regulatory discrepancy which systematically advantages larger firms over smaller ones. This reform would put smaller firms on a more level playing field in issuing securities. It would reduce the incentives of smaller firms to be acquired to have cheaper access to capital. And it would reduce the ability of larger companies to “put to work” what is essentially very inexpensive capital. This would thus reduce the incentives of both the acquiring and would-be target

companies--with the immediate result being increased diversification and decreased concentration of our capital markets.

### Conclusion

If the US capital markets are to remain the best in the world, we urge you to work with investors, other market participants, and regulators to implement some modest, but essential, reforms without delay. Thank you again for undertaking this important effort and I look forward to any questions.



**Brian Hahn**  
**Chief Financial Officer, GlycoMimetics, Inc.**

On behalf of the Biotechnology Innovation Organization

Before the United States House of Representatives Committee on Financial Services,  
 Subcommittee on Capital Markets, Securities, and Investment

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*Hearing on Legislative Proposals to Help Fuel Capital and Growth on Main Street*

May 23, 2018

**Executive Summary**

- GlycoMimetics is a clinical-stage biotechnology company based in Rockville, Maryland. The Biotechnology Innovation Organization (BIO) represents GlycoMimetics and 1,100 other innovative biotech companies, the vast majority of which are pre-revenue small businesses.
- GlycoMimetics undertook a successful IPO in January 2014 using key provisions in the Jumpstart Our Business Startups (JOBS) Act. In the six years since the JOBS Act became law, 260 biotech companies have gone public as emerging growth companies (EGCs).
- GlycoMimetics will lose its status as an EGC in January 2019, five years after our IPO. By losing this status, we will immediately be subject to onerous documentation requirements as set forth in Section 404(b) of the Sarbanes-Oxley (SOX) Act .
- BIO fully supports policies which build on the success of the JOBS Act and increases the flow of capital to innovative small businesses. BIO also fully supports policies which decrease capital diversions from the lab to unnecessary compliance burdens and supports companies once they are public. These policies include:
  - Extend the JOBS Act exemption from Section 404(b) mandates from 5 years to 10 years for EGCs
  - Expand the exemption from Section 404(b) by aligning the SEC definition of a non-accelerated filer with the proposed expanded SRC definition
  - Institute reasonable and effective SEC oversight of proxy advisory firms.
  - Require disclosure of short sales to curb manipulative short selling.
  - Make XBRL compliance optional for EGCs, smaller reporting companies (SRCs), and non-accelerated filers.



**Testimony of Brian Hahn**

Good morning Chairman Huizenga, Ranking Member Maloney, and Members of the Capital Markets, Securities, and Investment Subcommittee. My name is Brian Hahn, and I am the Chief Financial Officer of GlycoMimetics, Inc., a 48-employee public biotech company based in Rockville, Maryland. I am also the Co-Chair of the Finance and Tax Committee at the Biotechnology Innovation Organization (BIO), which represents GlycoMimetics and over 1,100 other growth-stage biotechs that are driving the search for the next generation of cures and breakthrough medicines.

The ability of growing businesses to access the public markets, as supported by the JOBS Act, is of paramount importance to biotechnology innovation because investment capital is the lifeblood of scientific advancement. It costs over \$1 billion to develop a single life-saving treatment, and most companies spend more than a decade in the lab before their first therapy is approved. During this long development process, virtually every dollar spent by an emerging biotech comes directly from investors. Expenses ranging from buy-in-bulk beakers to \$150 million clinical trials are all funded by investment capital because biotechs remain pre-revenue through their entire time in the lab and the clinic.

Early-stage innovators do not have the luxury of funding their product development through sales revenue. Instead, the groundbreaking research that leads to a company's first product is funded by a series of financing rounds from angel investors, venture capitalists, large pharmaceutical companies, and, eventually, public market investors. The capital burden of a pivotal clinical trial – which can require hundreds of patients in the clinic to meet the stringent safety and efficacy standards necessary to ensure patient care – often necessitates an IPO to fund this critical stage of the research process.

I am pleased to be here today to discuss policies that will help small growth companies like biotechs. My testimony today will address legislative proposals as well as the recommendations in the recently released report, which BIO helped develop, titled, "Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public". These proposals are the result of thoughtful consideration of the issues facing emerging companies like mine and would help small biotechs grow and eventually put a product on the market.

**Extend the JOBS Act Exemption from Section 404(b) Mandates of the Sarbanes-Oxley Act from 5 years to 10 years for EGCs**

Because pre-revenue small businesses like GlycoMimetics utilize only investment dollars to fund our work, we place a high value on policies like the JOBS Act that incentivize investment in innovation and prioritize resource efficiency. Any policy that increases the flow of innovation capital to emerging companies could lead to funding for a new life-saving medicine – while any policy that diverts capital to unnecessary and costly regulatory burdens could lead to the same treatment being left on the laboratory shelf.

The JOBS Act has been an unqualified success, enhancing capital formation and allowing companies to focus on science rather than compliance. It certainly helped pave the way for GlycoMimetics IPO in January 2014. As companies like mine face the end of the JOBS Act on ramp at the five-year mark, legislation being considered today that would extend this on ramp would be extremely beneficial for growing companies that stand to lose emerging growth company (EGC) status for no other reason than time, despite still qualifying by all other metrics.



When GlycoMimetics rolls off its EGC status in a few short months, we will be subject to onerous and expensive disclosure burdens as mandated by Sarbanes-Oxley (SOX) Section 404(b). This will be particularly damaging to our company as we are still years away from having a product on the market and generating revenue, but the disclosure requirements will siphon our precious capital away from science and divert it to compliance despite this.

Section 404(b) requires an external auditor's attestation of a company's internal financial controls that provides little-to-no insight into the health of an emerging biotech company – but is very costly for a pre-revenue innovator to comply with, making the JOBS Act exemption extremely valuable. As helpful as this five-year exemption is, the biotech development timeline is a decades-long affair. When I testified in front of this Committee in March 2017, I predicted that GlycoMimetics would still be in the lab and the clinic when our EGC clock expires – which is to say that we will still not be generating product revenue. As we come to the end of our five-year exemption, this prediction is holding true.

After our IPO, our audit fees increased by roughly \$500,000 due to the existing regulatory environment for public companies. Absent an additional exemption, we expect our Section 404(b) compliance obligations alone to more than double our costs to as much as \$1.1 million annually starting in January 2019 when our five-year exemption ends. This is a substantial amount that will be diverted from R&D and the clinic, and instead spent on compliance requirements that offer little to no benefit to our investors. My company is far from being an outlier in this situation – as I stated earlier, more than 260 biotechs have gone public since the JOBS Act was enacted, and a majority of these companies are still in the lab and years away from getting their drug approved and becoming a profitable company. It is counterproductive for them to face a full-blown compliance burden identical to those faced by large, multi-national revenue-generating company.

I'd like to thank Representatives Kyrsten Sinema and Trey Hollingsworth for their efforts in drafting H.R. 1645, *The Fostering Innovation Act*, as well as the Capital Markets Subcommittee and the House of Representatives for passing this important piece of legislation. This bill recognizes that a company that maintains the characteristics of an EGC is very much still an emerging company, even if it has been public for longer than five years. It provides a targeted exemption from Section 404(b) compliance requirements to companies in years 6-10 of being public who have a public float less than \$700M and average annual revenues less than \$50M. These restrictions ensure that only companies who are truly still EGCs are eligible – if a company eclipses the average annual revenues of \$50 million, their full compliance obligations kick in. I am hopeful that the Senate will also recognize the importance of the Fostering Innovation Act in a timely manner, before any more companies are rolled off the JOBS Act provisions and subject to the onerous auditor attestation burdens.

**Expand the Exemption from Section 404(b) by Aligning the SEC Definition of a Non-Accelerated filer with the Proposed Expanded SRC Definition**

Another way to help small business innovators avoid the burdens of Section 404(b) is to expand the definition of a non-accelerated filer under SEC rules. Under current SEC rules, companies qualify both as an SRC and a non-accelerated filer if their public float falls below \$75 million. SRCs benefit from scaled obligations under Regulation S-K and Regulation S-X, while non-accelerated filers are exempt from Section 404(b).



The SEC has issued a proposed rule that would increase the public float cap for SRCs to \$250 million and has asked for comment on adopting a similar definition for non-accelerated filers as well. Legislation being considered by this Committee today would also expand both definitions.

An expanded definition of non-accelerated filers would expand the universe of companies exempt from Section 404(b), which as I outlined above, would be a tremendous benefit to small business innovators like biotechs. As you might expect, the response to this request for comment has been overwhelmingly in support of also changing the definition of non-accelerated filers. In addition to BIO, there was strong support for this proposal by other industry leaders, including Nasdaq, NYSE, National Venture Capital Association, Independent Community Bankers of America, Advanced Medical Technology Association, CONNECT, and the Corporate Governance Coalition for Investor Value.

Further, this is an issue that has repeatedly garnered the attention of the SEC in a number of venues – raising the thresholds of both definitions has been recommended by the SEC Advisory Committee on Small & Emerging Companies in 2013, 2015, and 2017, and has been recommended on the SEC Government-Business Forum on Small Business Capital Formation every year since 2009. The Treasury Department and the NEC also endorsed this proposal in Treasury's 2017 Capital Markets Report.

#### **Institute Reasonable and Effective SEC Oversight of Proxy Advisory Firms**

With the rise of institutional investors over the last several decades, the role of proxy advisory firms has grown to have an outsized influence on the decision-making processes of emerging biotechs and their shareholders. Institutional investors own more than two-thirds of all shares in public companies, with more than 90% of them regularly voting their shares. These investors rely on proxy advisory firms to provide vote recommendations. However, these vote recommendations are not always in the best interests of the company, the shareholders, and most importantly, the patients.

Just two firms control over 97% of the proxy advisory firm market. As the report notes, this effective duopoly "operates with little transparency, significant conflicts of interest, and [has] been prone to making errors in analysis and when developing voting recommendations". For companies like GlycoMimetics and other biotechs, these issues are especially damaging. Biotech small businesses operate in a unique industry that values a strong relationship with investors, yet they often are held to standards that are not applicable to their company and forced to engage in proxy fights over issues that do not add value for shareholders. When a proxy firm issues a recommendation that is not applicable to an emerging biotech and remains unwilling to consider alternative approaches or methodologies, it can harm a company's relationship with its shareholders and distract management from the core business of the company. Even in instances where a proxy firm has not yet made a recommendation, their influence is felt in boardrooms across the industry as companies strive to structure their corporate policies to satisfy the firms – rather than making decisions in the best interest of the company's growth.

BIO believes that proxy advisory firms should be more transparent and open to input in their standard-setting process, particularly with regard to issues unique to small businesses. We also believe that the firms with conflicted business models should be required to avoid potential conflicts of interest. I commend Representatives Sean Duffy and Gregory Meeks for introducing H.R. 4015, *The Corporate Governance Reform and Transparency Act of 2017*, and I want to thank this subcommittee, and the House of Representatives, for



passing it last December on a bipartisan basis. I am hopeful that the Senate will take up and pass the legislation soon.

BIO appreciates Rep Duffy's attention to the proxy issues small companies face and would also like to thank him for H.R. 5756, which would adjust certain resubmission thresholds for redundant shareholder proposals that burden many small biotechs.

**Require Disclosure of Short Sales to Curb Manipulative Short Selling**

The unique business model of groundbreaking innovation leaves emerging biotechs particularly vulnerable to stock manipulation via abusive short selling strategies. Biotech companies depend on the public market for the capital necessary to fund late-stage clinical trials. However, the high-stakes nature of their research, their often-thinly-traded stocks, the limited publicly available information about ongoing trials, and their dependence on a small portfolio of products or product candidates can be exploited by short sellers who prioritize short-term profits over the long-term health of patients. Abusive short trading strategies harm growing companies and disincentivize long-term investment in innovation.

BIO acknowledges that appropriate shorting can support the stable, liquid markets that fuel the growth of emerging biotech innovators. However, we strongly believe that the current lack of transparency related to short positions is enabling trading behaviors that unfairly harm growing companies, long-term investors, and, most importantly, patients. BIO members face a consistent and significant risk of manipulation by short sellers, who are protected by the lack of disclosure required of short positions.

Specifically, growing innovators face campaigns mounted by manipulative short investors who spread online rumors about small biotech companies, or publish false or misleading data about clinical trials or marketed therapies, in order to drive down their stock price. The end goal of this manipulation is to generate a quick profit for short sellers at the expense of the long investors who support life-saving innovation. Recently, a strategy has emerged wherein manipulative short investors take a short position in a biotech company's stock and then immediately file spurious patent challenges through the Patent Office's *inter partes* review (IPR) process. The IPR process allows them to file a challenge even without a competing patent or any specific stake in the company's science. These spurious challenges are intended to drive down the stock price, which reliably happens as news spreads that the company's patents may be in jeopardy.

BIO believes that increased short transparency would shine a light on manipulative behaviors, allow market participants to make informed trading decisions, and ensure equitable rules for all types of investments.

**Make XBRL Compliance Optional for EGCs, Smaller Reporting Companies (SRCs), and Non-Accelerated Filers.**

BIO believes that growing companies should not have to bear the costs of the eXtensible Business Reporting Language (XBRL) reporting requirement until it has been demonstrated to be cost effective and useful to investors.

XBRL is an attempt to make it easier for investors to compare financial data, but as with many of the issues I have discussed today, it disproportionately affects smaller issuers due to its one-size-fits-all approach. The simple fact is, biotech investors are less concerned with



the reporting metrics that XBRL compares, and more concerned with the actual science of the company and their path toward FDA approval, and, ultimately, getting a drug on the market and to patients.

I'd like to thank Representative David Kustoff, for recognizing the outsized impact that XBRL compliance has on small companies like mine by introducing H.R. 5054, *The Small Company Disclosure Simplification Act of 2018* in February. Under this legislation, companies would still be able to opt-in if they or their investors deemed it necessary to do so. However, it would fully exempt EGCs from XBRL reporting requirements, and would also provide a temporary XBRL exemption for companies with revenues below \$250 million. It is yet another example of the Financial Services Committee's willingness to support smaller emerging companies. The inclusion of a requirement for the SEC to study XBRL to improve its utility and cost-effectiveness also provides an opportunity for the SEC to improve XBRL in the future.

#### Conclusion

Thank you for the opportunity to testify today in support of policies to help small business innovators like biotech go public and continue to grow and thrive as public companies. As the IPO report and the testimony you've heard today demonstrate, despite the success of landmark legislation like the JOBS Act, there is still work to be done in order to make the public markets as efficient and strong as possible. Biotechs are in a constant search for capital as they undertake the monumental task of finding cures for patients, and going public is often one piece of the puzzle that ultimately leads to bringing those cures to the market. However, once a company goes public, an even larger puzzle of outdated disclosure regimes, as well as one-size-fits-all and overly burdensome requirements emerges.

I believe the proposals being considered before the Subcommittee today will support the growth of emerging, innovative companies, and continue to spur investment in breakthrough scientific discoveries, and ultimately lead to a new generation of therapies for patients across the country, and the world. I hope Congress recognizes the landmark success of the JOBS Act and its impact it has had on the biotechnology industry in the last six years. More importantly, I hope my testimony and this hearing today has shown that there is still work to be done in order to continue supporting the lifesaving innovative treatments companies like GlycoMimetics are developing today.

Finally, I would like to thank the Committee again for your efforts in finding new ways to support biotech companies like GlycoMimetics in our relentless pursuit to bring new therapies to patients. By constantly working to modernize legislation and recognizing that one-size-fits-all requirements for public companies are often especially onerous to smaller companies like my own, you are helping to support us in that pursuit. I look forward to working with you on these issues and I am happy to answer any questions you may have for me today.



Testimony of Edward S. Knight  
 Executive Vice President  
 Global Chief Legal and Policy Officer  
 Nasdaq, Inc.  
 Before the House Financial Services Committee  
 Subcommittee on Capital Markets and GSEs  
 May 23, 2018

Chairman Huizenga and Ranking Member Maloney,

Thank you for the opportunity to testify in support of legislation designed to improve economic growth, create jobs, and provide investors with more opportunity to grow their savings. That is what we can expect if we modernize the public company model, while preserving critical investor protections.

Nasdaq recently noted the one-year anniversary of launching its Revitalize Initiative ([business.nasdaq.com/revitalize](http://business.nasdaq.com/revitalize)) aimed at highlighting a set of ideas that our listed companies, stakeholders and investors tell us will restore the vibrancy of the capital markets. These ideas are broadly grouped around three areas of the securities law: the proxy process, the disclosure rules, and the market structure that applies to the U.S. equity markets.

A little over a year ago, I testified on a similar topic, "The JOBS Act at Five", as Congress began its deliberations concerning how best to build on the foundation of the JOBS Act. Since then, Congress, the SEC, and the Administration — acting largely on a bipartisan basis — have made progress in seeking to improve economic conditions, without new appropriations or changes to the tax code. That is the beauty of the capital markets: by making them more efficient and modern, we stimulate growth and job creation, and the fiscal impact is positive.

And when the business community understands policymakers are willing to work alongside them to effect change, there are other less tangible results. As one economist observed: "business confidence is the cheapest form of economic stimulus."<sup>1</sup>

We are encouraged the following has occurred since the JOBS Act hearing:

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<sup>1</sup> Lawrence H. Summers (see, e.g., The Business Roundtable's Outlandish Tax Cut Claims, *The Washington Post* (October 23, 2017)).



- The U.S. Department of the Treasury issued a comprehensive Capital Markets Report that supported disclosure reform, proxy advisory firm reform, and market structure reform for small cap stocks.<sup>2</sup>
- The House passed the Budd / Meeks legislation, H.R. 3903, extending confidential filing provisions. The Senate has offered a bipartisan companion bill.<sup>3</sup>
- Separately, the SEC has acted to broaden confidential filings.<sup>4</sup>
- The House passed the Duffy / Meeks proxy advisory firm reform bill, H.R. 4015.
- Chairman Huizenga's conflict minerals bill, H.R. 4248, passed the full House Financial Services Committee.
- The SEC held a "Roundtable" on April 23 that addressed the market structure for thinly-traded, exchange-listed securities, both equities and exchange-traded products.<sup>5</sup>
- The SEC moved forward with proposed rulemaking to modernize and simplify Regulation S-K, as instructed in the FAST Act.<sup>6</sup>
- The SEC issued Staff Bulletin 14I reducing burdens of proxy access.<sup>7</sup>

Equally important, a broad coalition of interests, from the Chamber of Commerce and the National Venture Capital Association to the Biotechnology Innovation Organization (BIO) and TechNet to SIFMA, the American Securities Association and the Equity Dealers of America, have come forward to embrace this agenda.<sup>8</sup>

<sup>2</sup> U.S. Department of the Treasury, A Financial System That Creates Economic Opportunities: Capital Markets (October 6, 2017), available at <https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf>.

<sup>3</sup> Encouraging Public Offerings Act of 2018, S. 2347, 115<sup>th</sup> Congress.

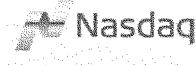
<sup>4</sup> SEC Press Release, Draft Registration Statement Processing Procedures Expanded (June 29, 2017), available at <https://www.sec.gov/corpfin/announcement/draft-registration-statement-processing-procedures-expanded>.

<sup>5</sup> Roundtable on Market Structure for Thinly-Traded Securities, available at [https://www.sec.gov/video/webcast-archive-player.shtml?document\\_id=042318-roundtable-thinly-traded-securities](https://www.sec.gov/video/webcast-archive-player.shtml?document_id=042318-roundtable-thinly-traded-securities). See also SEC Press Release 2018-65, available at <https://www.sec.gov/news/press-release/2018-65>.

<sup>6</sup> FAST Act Modernization and Simplification of Regulation S-K, Securities Exchange Act Release No. 34-81851 (October 11, 2017), 82 FR 50988 (November 2, 2017).

<sup>7</sup> Available at <https://www.sec.gov/interp/legal/cfslb14i.htm>.

<sup>8</sup> Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public, available at [https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/04/IPO-Report\\_EXPANDING-THE-ON-RAMP.pdf](https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/04/IPO-Report_EXPANDING-THE-ON-RAMP.pdf).



I want to focus my comments today on five initiatives that we believe are worthy of the Subcommittee's favorable consideration:

- Rep. Tom Emmer's H.R. 5877, regarding Venture Exchanges, which would allow certain smaller publicly-listed companies to choose to aggregate the trading of their securities on a single exchange to enhance liquidity and reduce fragmentation in the market;
- Legislation to simplify the quarterly filing financial reporting regime, including Rep. Ann Wagner's potential draft legislation to allow Form 10-Q optionality;
- Legislation that matches short selling disclosure with disclosure required of other investors;
- Proxy process reform legislation, including Rep. Sean Duffy's H.R. 5756, designed to modernize the submission of proposals for inclusion on corporate proxies; and
- Legislation expanding testing the waters and confidential filing exemptions.

#### **Venture Exchange Legislation**

As the founder of electronic trading, Nasdaq views market innovation as a tremendous force for good, unlocking competition and unleashing the flow of capital to catalyze economic activity. Yet, as markets have advanced, the fundamental structure that underpins them has not evolved to benefit all market segments equally.

Despite incremental improvements to markets in recent years, liquidity and the trading experience for small and medium growth companies, and investors in these companies, still lags far behind that of larger issuers. For small and medium growth companies—those with a market capitalization below \$1 billion, particularly when the lower market cap is accompanied by low daily trading volume—relatively small orders can create dramatic price movements. This increases costs for both the companies and their investors. For example, regardless of the listing market that a company may choose, small and medium growth companies have shown a worsening incidence of high-volatility days, which increases investor confusion and undermines confidence in our markets.

This liquidity dilemma stems from a long-term trend towards fragmentation, where liquidity has spread across an increasing number of trading venues. As recently as 15 years ago, more than 90% of liquidity was often concentrated in a single market with the small remainder spread over an additional eight to ten other exchanges and electronic communications networks. Today, liquidity is spread thinly across fifty or more venues.

Nasdaq believes allowing smaller issuers to choose to concentrate that disaggregated liquidity onto a single exchange, with limited exceptions, will allow investors to better source liquidity. In addition, investors will enjoy a higher level of transparency because exchanges are required to display their best quotes to the public, and most exchanges



choose also to publish full supply and demand information (i.e. order book depth information) within their markets.

Thus, Nasdaq recommends permitting issuers to choose to trade in an environment with consolidated liquidity as would be allowed under the Venture Exchange Legislation. By creating a market for smaller issuers that is voluntary for issuers to join and largely exempt from the UTP obligations—subject to key exemptions—we can concentrate liquidity, to reduce volatility and improve the trading experience. Exchange trading would likely further concentrate liquidity and limit fragmentation. The net effect would be a substantial “thickening” of the liquidity crust on the exchange that lists the security.

Nasdaq has made an application at the SEC, which would adopt elements of this idea on our exchange, and we are proud this proposal has attracted wide support, including from the Chamber of Commerce and SIFMA. The legislation would expand this idea for a larger number of companies across existing and new exchanges. The Venture Exchange legislation provides a comprehensive framework, which will ensure that the benefits are realized in the near term. We appreciate the thoughtful diligence of Rep. Tom Emmer and his staff for the constructive balance contained in H.R. 5877 and look forward to this Subcommittee moving forward with consideration of this innovative proposal.

#### **Form 10-Q Optionality**

The Securities Exchange Act of 1934 (1934 Act) and the rules adopted thereunder require most SEC registrants to file a quarterly report with the SEC on Form 10-Q. The Form 10-Q includes condensed financial information and other data prepared by a company and reviewed by its independent auditors. The purpose of Form 10-Q is to update information included in annual Form 10-Ks or, for new companies, in securities registration statements previously filed under the 1934 Act or the Securities Act of 1933 (Securities Act or 1933 Act). The SEC's integrated disclosure system is designed so that the instructions in the various forms under the 1933 and 1934 Acts refer to Regulation S-X for financial statement disclosures and Regulation S-K for the required nonfinancial statement disclosures.

In today's market, to reach investors quickly, companies provide key data via an earnings press release each quarter. For virtually all investors, the press release is the quarterly report where they obtain key information and on which they make investment decisions. Yet companies are then required to file a formal Form 10-Q document with the SEC, which is complex, time-consuming, and provides little additional actionable information that cannot be found in the press release. By establishing simple guidelines, the press release can replace the Form 10-Q entirely for issuers that prefer to report quarterly information in that format, aligning regulatory and shareholder interests and significantly decreasing corporate reporting red tape. The current two-step process frustrates the goals of modern disclosure since retail investors rely on the press release that may be missing some important information, which appears buried in the Form 10-Q. The legislation would move all the disclosure into single press release and accompanying Form 8-K. And, it can be done without reducing the key disclosures that investors rely upon or changing the materiality standard that has been the compass for investors for nearly a century.



We understand that Rep. Ann Wagner will offer draft legislation that would address this issue and allow public companies to have optionality with respect to Form 10-Q filings. We support the Wagner legislation and look forward to working with the Subcommittee to see that bill move forward.

#### **Short Selling Transparency**

As Congress has recognized, it is incongruous that certain investors who accumulate long positions are required to publicly disclose their holdings, but there is no corresponding obligation for short sellers to do so, including those using synthetic or derivative instruments, which allow an investor to profit from a loss in value of the underlying security. This asymmetry has several deleterious effects: it deprives investors of information they can use to effect meaningful investment decisions, it deprives companies of insights into trading activity and limits their ability to engage with investors, and it deprives the market of information to ensure it functions efficiently and fairly. The Commission's Dodd-Frank rulemaking made important enhancements to transparency, and it deserves credit. However, Dodd-Frank provides the Commission with the mandate to make further enhancements, and lift the veil of secrecy behind which short sellers operate, and the SEC has not yet done so.

The obligation of investors to disclose long positions, and when they must do it, is part of a 49-year old regulatory disclosure regime and stems from amendments to the Securities Exchange Act of 1934 set forth in the Williams Act, adopted by Congress in 1968. As currently enacted, these rules require, among other things, investment managers and funds that own or have discretion over prescribed amounts of equity securities, regardless of whether they are registered with the Commission, to disclose their long positions on Form 13F, Schedule 13D and/or Schedule 13G, depending on the circumstances. Such investors must generally disclose their long positions on Schedule 13F within 45 days of the end of each calendar quarter, subject to delays based on requests for confidentiality. Further, when such investors acquire beneficial ownership of more than five percent of the voting class of a company's equity securities, they are generally required to file a Schedule 13D with the Commission. This filing must be made within ten days after the five percent threshold is exceeded.

However, if such investors are either Qualified Institutional Investors or Passive Investors, they may make such disclosure on Schedule 13G within 45 days of the end of a calendar year, subject to updated disclosure-based changes in ownership positions.

There are no comparable public disclosure requirements in the U.S. applicable to the accumulation of short positions. Instead, short sellers can amass short positions secretly, abetted by increased use of derivatives and other synthetic instruments. This is particularly untenable in light of the fact that in recent years, investors with short positions, or derivative equivalents, have taken a more activist role in corporate policy and governance. Because there is no disclosure required of short positions, the investing public and issuers do not know when such circumstances exist or whether the incentives of these investors are inconsistent with corporate policies and objectives. As a result, without full



information about short positions maintained, investors and companies are left to speculate on short positions, to the detriment of market efficiency, price discovery and shareholder engagement. This information deficiency potentially subjects a company's stock price to trading and volatility based on rumor, speculation and innuendo, not facts or substantive analysis.

In December of 2015, I wrote to the SEC outlining these points and requested that the Commission promulgate rules for a short selling regime. This position has been echoed by other organizations such as BIO, NYSE and others. It is time for Congress to step in and require it.

#### **Proxy Access Reform**

Nasdaq supports shareholder-friendly regulations that provide healthy interactions between public companies and shareholders. However, current regulations governing the way shareholders access a company's proxy statement can poison the company-shareholder relationship by amplifying the voice of a tiny minority, over the best interests of the vast majority. The cost to public companies, and their shareholders, in legal expense, let alone the time and attention of management and boards, is real and significant.

According to The New York Times, three individuals were responsible for 70% of all proposals sponsored by individuals among Fortune 250 companies in 2014.<sup>9</sup> The current process is costly, time-consuming and frustrating for companies, which in aggregate each year must address hundreds of such proposals plus address the many others threatened. Recent action by the SEC to clarify when an initial proposal can be excluded as an ordinary business matter is helpful, but Congress should adopt the proposed legislation to modestly increase the shareholder support that a proxy proposal must receive before a properly introduced proposal can be reintroduced, time after time, at future meetings. We support the alternatively proposed thresholds of 6 percent, 15 percent, and 30 percent of shareholder support for the first, second, and third time a matter is considered within five years before the same proposal can be reintroduced.

In addition, we continue to monitor opportunities to improve the initial thresholds for proxy access. For instance, the \$2,000 in market value threshold seems out of date and ill-suited for most companies.

The SEC should study the categories of topics suitable for shareholder proxies and modify its rules accordingly, to ensure proposals considered at annual meetings are properly placed before shareholders and are meaningful to the business of the company, and not related to ordinary business matters.

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<sup>9</sup> Grappling With the Cost of Corporate Gadflies by Steven Davidoff Solomon (August 19, 2014), available at <https://dealbook.nytimes.com/2014/08/19/grappling-with-the-cost-of-corporate-gadflies/>.



Rep. Sean Duffy has proposed legislation that we support to adjust the resubmission thresholds for proxy proposals. H.R. 5756 offers a fair and balanced approach for companies and those seeking proxy access.

#### **Testing the Waters and Confidential Filing Exemptions**

There are two draft bills before us that deal with the important topics of testing the waters and confidential filings at the SEC.

The ability to file draft registration statements confidentiality at the SEC, which was first mandated for Emerging Growth Companies (EGCs) through the JOBS Act, would be expanded to all companies by statute in one bill. We support this legislation.

The JOBS Act confidential filing provision removed an impediment to going public that resulted in many new, successful public companies, without any loss of investor protections. The historical process included associated costs in terms of the loss of business confidential information that caused many companies to defer going public, unless all other options were exhausted. Now, companies can explore all capital raising opportunities simultaneously.

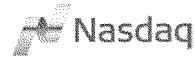
The SEC under Chairman Clayton quickly recognized the benefits of expanding the opportunity to file confidentially, and acted through its use of staff discretion. The proposed legislation would wisely codify this action.

The legislation would also allow all companies, not just Emerging Growth Companies, to test the waters. Again, this provision originally found in the JOBS Act has proven to facilitate companies going public without harming investors. The new bill allows the SEC to issue regulations to impose terms and conditions on issuers, other than Emerging Growth Companies, that take advantage of the ability to test the waters in order to ensure investors are protected. We support this protective provision.

The second bill would codify a rule the SEC proposed in 2010 that would allow well-known, seasoned issuers to authorize an underwriter to act as its representative in communicating about an offering of the issuer's securities prior to the filing of a registration statement. We believe this is a modest proposal that practically extends the benefits of an existing capital-raising provision to an issuer's agents or representatives.

#### **Other Proposals Noticed by the Subcommittee**

The Subcommittee is also considering several legislative items on which we have worked with a broad coalition. These bills make XBRL optional for EGCs, increase research coverage for smaller companies, direct the SEC to align several smaller reporting definitions, expand the JOBS Act by eliminating certain phase outs, and increase the ability of mutual funds to invest in EGCs. We join our coalition partners at BIO, the U.S. Chamber, Equity Dealers of America, National Venture Capital Association, SIFMA, TechNet and the American Securities Association and others to support this legislation.

**Conclusion**

We appreciate the opportunity to present Nasdaq's views on a set of proposals that preserve critical investor protections, while facilitating capital formation, job growth and innovation.

These are not partisan bills. They should not be viewed as controversial. They are part of the natural process of responding to the ever-changing economy and adjusting rules based upon years of experience. This is a healthy process that has served to keep our markets modern and competitive.

Thank you Mr. Chairman and Members of the Subcommittee.



**Written Testimony of Brett Paschke**

**Managing Director, Head of Capital Markets, William Blair**

**on behalf of**

**the Securities Industry and Financial Markets Association**

**before the U.S. House of Representatives**

**Committee on Financial Services**

**Subcommittee on Capital Markets, Securities, and Investment**

**Hearing entitled “Legislative Proposals to Help Fuel Capital and  
Growth on Main Street”**

**May 23, 2018**

Chairman Huizenga, Ranking Member Maloney, and distinguished members of the Subcommittee, thank you for the opportunity to testify today on the importance of preserving the vibrancy of our public capital markets. My name is Brett Paschke and I am the Head of Equity Capital Markets at William Blair, testifying today on behalf of the Securities Industry and Financial Markets Association (SIFMA)<sup>1</sup>. William Blair is a premier global boutique, headquartered in Chicago, with expertise in investment banking, investment management, and private wealth management. On behalf of individuals, families, private and public pension funds, endowments and foundations, we manage approximately \$100 billion in client investments. On the capital markets side of our business, for which I am responsible, we are best known for serving the needs of small and mid-cap growth companies, including many innovative leaders in technology, health care and life sciences. Over the last ten years, we have been an underwriter on approximately 20 per cent of all US-listed IPOs. We provide sell side research for over 600 public companies, we are an active market maker in over 3,600 stocks, and our institutional sales force covers many of the world's leading growth stock investors. I will do my best to bring these perspectives and experiences to the Subcommittee today.

I joined William Blair directly out of Harvard Business School 21 years ago because I wanted to help business founders raise capital to build companies, invent products, solve problems, cure diseases, create jobs and provide wealth creation opportunities for the investing public. All these years, and many deals later, I am still motivated and inspired by the opportunity to help our clients achieve their missions. I served on the IPO Task Force in 2011 that put together the recommendations that

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<sup>1</sup> SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over \$2.5 trillion for businesses and municipalities in the U.S., serving clients with over \$18.5 trillion in assets and managing more than \$67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>.

became the JOBS Act and am very pleased to be here today to continue that work. SIFMA welcomes the attention that this Committee, the Administration, the Securities and Exchange Commission (SEC) and other policymakers have paid to the important issue of preserving the vibrancy of our public capital markets.

It is difficult to overstate the change that has occurred in U.S. public capital markets over the last twenty years. An explosion in private funding, the rise of index and passive investing, technological advances in our equities markets such as electronic trading (which improved liquidity, ease of trading, availability of information about issuers, and the ability of retail investors to participate in public markets), the development of hedge funds, high frequency trading, the maturation of international exchanges, consolidation in the investment banking industry, and yes, the impact of regulations from Sarbanes-Oxley and Dodd-Frank have all played a role in reshaping our markets. Unfortunately, not all the changes have been positive. From a peak in 1996, the total number of publicly listed companies in the U.S. has fallen by almost 50%, from 8,000+ to just over 4,000. The U.S. now has about as many public companies as it did in the early 1980s. The annual number of US-listed IPOs dropped from a peak of almost 750 in 1996 to between 28 and 255 annually for the period from 2001 to today, despite the attempts of policymakers to revitalize this market through the Jumpstart Our Business Startups (JOBS) Act of 2012 and follow-on legislation. I spend much of my time meeting with private company executives, their Boards and their investors, discussing alternatives for raising capital and realizing value. More often than not these decisionmakers cite the costs of going and staying public, the demands of quarterly reporting, regulatory and corporate governance requirements, and the reduced number of success stories as reasons that they prefer to be funded privately or to sell their business to a strategic acquirer or private equity fund. The explosion of private capital markets, led by angel investors, venture capital

firms and private equity firms has allowed companies to grow their business and valuations without ever tapping public markets.

It is worth discussing why this evolution matters. One important implication is that many startup companies are being built to be sold, as opposed to being built to be independent public companies. This often does not lead to the same level of expansion and job growth that a long life as an independent public company does. Another important implication is that access to the private markets is limited to a much smaller group of high net worth individuals and institutions, effectively excluding retail investors from the value creation that occurs with these companies. Our public markets provide much greater access to wealth creation, from direct retail investing to the mutual funds that manage money on behalf of individuals, retirement plans, pension funds, and endowments. Our public capital markets also remain critical for issuers and investors with their provisioning of deep liquidity that private markets simply cannot replicate. The liquidity in the market for public securities allows investors to quickly enter and exit even large positions, making equities an attractive asset class for investors everywhere. Public capital markets yield more accurate valuations of corporate securities as investors have access to financial information from across markets, and the accompanying public disclosure distributes important information on market trends. While private markets are important in their own way and are undoubtedly popular with entrepreneurs, they are unable to match the broad access, liquidity, and other benefits of public markets. Even as they encourage innovation, policymakers should be concerned about the current trend of companies shunning public markets and so again SIFMA commends the focus on these topics.

Indeed, the need to support our public capital markets is why SIFMA, the U.S. Chamber of Commerce, and a broad coalition of stakeholders joined together recently to produce a report

entitled “Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public.”<sup>2</sup> The signatory organizations for that report believe that the recommendations contained within could increase the attractiveness of public markets for issuers. SIFMA believes the report balances the need to streamline issuer obligations with a recognition that investor confidence is a critical component to the vibrancy of public capital markets. We also support many of the draft bills that have been released alongside this hearing. Some of these proposals – such as updating shareholder resubmission thresholds and allowing underwriters to communicate with prospective investors on behalf of well-known seasoned issuers (WKSIs) – are examples of thoughtful updates to our securities laws that will help those laws keep pace with the intense changes our public markets have undergone.

With that in mind, I would like to discuss several specific recommendations within the coalition report that SIFMA believes could have a significant positive impact on public markets. Let me make an important caveat -- we do not believe that any single policy change will reverse the decline in publicly listed companies or unlock the IPO market. The authors of the JOBS Act understood this and wisely took a holistic approach to improving capital formation. Policymakers today should take on our present challenges with a similar mindset.

#### **Lengthen the EGC On-Ramp**

Congress began addressing the issue of the deteriorating IPO markets in the JOBS Act of 2012, which created a new category of issuer, the Emerging Growth Company (EGC), and created an “on-ramp” of scaled corporate disclosure requirements for those issuers through their first five

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<sup>2</sup> [https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/04/IPO-Report\\_EXPANDING-THE-ON-RAMP.pdf](https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/04/IPO-Report_EXPANDING-THE-ON-RAMP.pdf)

years as a public company. As stated earlier, SIFMA believes the high costs today of being a public company relative to the costs of being a private company have shifted the issuer incentives away from public markets. The JOBS Act's on-ramp of tailored financial reporting requirements and auditing and accounting standards greatly eased the burden for smaller companies going public and virtually all the post-JOBS Act IPOs have been EGCs. Unfortunately, many smaller companies time-out of EGC status before reaching the gross revenue limitation of \$1 billion. Even five years after going public an issuer may not be a fully mature company, especially if it is still developing its core intellectual property, such as a pharmaceutical or technology product. Congress has an opportunity to build on the JOBS Act's successes by extending the on-ramp provisions for issuers from five to ten years while maintaining the current revenue threshold. SIFMA is glad to see that draft legislation achieving this change was released by the Committee in conjunction with this hearing. Providing a longer runway for companies to scale up to the full public reporting requirements should incentivize more issuers to go and stay public.

### **Testing the Waters**

Another important provision of the JOBS Act was the ability to file draft registrations statements confidentially, which allows companies interested in an IPO to manage the timing and release of their proprietary and financial information. The benefits of confidential filing, however, are multiplied when coupled with the JOBS Act's "testing the waters" provision that allowed EGCs to gauge investor interest in securities prior to an offering. These provisions are especially popular with those whose businesses rely on complex intellectual property (especially in the technology and biotechnology sectors) and who benefit from additional opportunities to explain their business and outlook to investors. The SEC has already expanded the confidential filing flexibility to all issuers

but has not expanded “testing the waters” to all issuers. While much effort has been targeted on improving the environment for smaller prospective issuers, policymakers should also find ways to attract companies of all sizes to the public market, including those that have grown to maturity in private markets. These companies would also greatly benefit from the flexibility to gauge interest among a wider array of investors and reduce uncertainty before formally launching an IPO. In that regard, “testing the waters” benefits both investors and issuers and is an excellent example of a JOBS Act reform that should be expanded from FGCs to all issuers.

#### **Research Rule 139**

The provisioning of research on publicly traded companies is one of the most critical, but least understood, facets of our public capital markets. Research coverage of companies can improve liquidity in thinly-traded stocks by increasing investor interest and awareness. The importance of research for healthy capital markets should remain a key focus in capital formation discussions as this coverage is vital for investors throughout all stages of a company’s life, and diminished research coverage of small cap companies should raise serious concerns. SHC Rule 139 provides a safe harbor for research produced by broker-dealers participating in a distribution if the issuer is a large reporting company under the ‘34 Act. This safe harbor ensures that research is not considered an offer of securities, with the accompanying liability. At present, Rule 139’s safe harbor only shelters research reports on large reporting companies or S-3 eligible issuers. This arbitrary limitation means that coverage of smaller issuers must cease during an offering of their securities, a time when research would be quite valuable to investors. Impeding the provisioning of research does not protect investors in these cases and the disparate treatment unnecessarily disadvantages smaller

companies. We recommend that policymakers expand the Rule 139 safe harbor to research of all issuers.

#### **Eliminate “Baby-Shelf” Restrictions**

Shelf registration is a commonly-used method of accessing capital markets, as it allows issuers to pre-register securities offerings in advance of sale, with the actual offering occurring when the issuer needs or wants capital. The flexibility of shelf registrations, filed using Forms S-3 and F-3, can lead to significantly lower costs for issuers. Unfortunately, many small-cap issuers (including EGCs) are subject to “baby-shelf” rules that limit the amount of capital they can raise through shelf registrations. Today, baby-shelf rules limit companies with less than \$75 million in public float to selling securities worth no more than 1/3<sup>rd</sup> of their public float. This limitation makes it very difficult for small-cap companies to timely and opportunistically raise the capital needed for expansion or research & development. EGCs that need to raise more than is allowed under the “baby-shelf” rules may be forced to undergo either a private placement (which typically forces securities to be offered at a discount due to their diminished liquidity) or a confidential S-1 filing (which entails a far more complex registration process). Allowing all issuers, including EGCs and small-cap issuers, to take advantage of shelf registration without a limit on the amount they can raise will make public markets far more attractive to small-cap issuers. This change will also create new opportunities for retail investors to invest in early-stage companies and possibly to realize higher returns. Eliminating the baby-shelf cap strikes a sound balance between assisting issuers and protecting investors, as the SEC still requires detailed disclosures from would-be issuers about the type of securities offered and the use of the proceeds.

### Diversified Fund Limits

Any attempt to revitalize our public markets must reckon with the extraordinary growth that has taken place in the registered mutual fund industry over the last 20 years. Mutual funds – the buy side of our equity markets – have become an increasingly important way that households and investors access our capital markets. Since 1990, the number of total registered mutual funds has grown about ten times, mean fund size has more than doubled, and open-end fund holdings of US corporate equities has reached approximately 24% of the entire market. This growth means the investment decisions of mutual funds today are an important aspect of our public capital markets. However, large mutual funds' investing preferences have shifted away from IPOs, and especially small IPOs. Several factors explain this change, but one that policymakers have rightfully paid attention to is the diversified fund limits that govern mutual fund investments. The current 10% limit on mutual fund positions limits interest in small-cap IPOs because as large funds' assets under management (AUM) grows, the 10% limit means that any investment in a small IPO will have a negligible impact on overall fund return. Asset managers seeking returns are increasingly passing on small IPOs to focus on larger ones and demanding greater returns from small IPOs to justify an investment at all. Declining mutual fund interest in small IPOs also materially weakens the trading environment for small-cap stocks and likely deters small firms from joining our public markets. SIFMA believes that the proposed legislation, providing for a modest increase in the diversified fund limit threshold from 10% to 15% of voting shares, will increase buy-side interest in small IPOs and improve liquidity in small-cap stocks. However, we urge Congress also address the tax implications of such a change, because the tax code currently limits Regulated Investment Company (RIC) status to funds that meet the 10% threshold and raising the diversified fund limit cap without addressing the tax implications will effectively leave the status quo in place.

**Conclusion**

Policymakers certainly have a challenge before them -- improving the vibrancy of our public markets while balancing investor protections. But the U.S. capital markets are the envy of the world and worth the effort to preserve. SIFMA and its members stand ready to assist the Committee and the SEC in this important endeavor. Thank you for this opportunity to testify today, I look forward to your questions.

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## **Statement of the U.S. Chamber of Commerce**

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**ON: Legislative Proposals to Help Fuel Capital and  
Growth on Main Street**

**TO: House Committee on Financial Services,  
Subcommittee on Capital Markets, Securities and  
Investment**

**BY: Thomas Quaadman, Executive Vice President, Center  
for Capital Markets Competitiveness, U.S. Chamber of  
Commerce**

**DATE: May 23, 2018**

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1615 H Street NW | Washington, DC | 20062

The Chamber's mission is to advance human progress through an economic,  
political and social system based on individual freedom,  
incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than three million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Chairman Huizenga, Ranking Member Maloney, and members of the Subcommittee on Capital Markets, Securities, and Investment. My name is Tom Quaadman, executive vice president of the Center for Capital Markets Competitiveness (“CCMC”) at the U.S. Chamber of Commerce (“Chamber”).

This hearing, “Legislative Proposals to Help Fuel Capital and Growth on Main Street” is a continuation of this Committee’s good work over the last several years to help provide growing businesses with the capital they need to create jobs, expand, and innovate. I am pleased to provide testimony on behalf of Chamber members regarding several of the proposals that are being considered today.

As members of this Committee are aware, the post-recession recovery over the last decade was extremely weak by historical standards. From 2010-2017, for example, gross domestic product (GDP) in the United States failed to achieve 3% growth in any given year, well below the post-World War II historical norm. To put the importance of 3% growth into perspective, if our economy moved from 2.5% growth to 3% growth, average annual incomes would rise by \$4,200 and 1.2 million jobs would be created over the next decade. These are simply statistics, but underlying them is the opportunity for millions of Americans to create a better life for themselves and their families.

Not only was the post-recession recovery historically weak, it was also remarkably uneven across the country. A striking 2016 report from the Economic Innovation Group found that 50% of post-crisis new business creation occurred across only *twenty* counties in the United States.<sup>1</sup> Coupled with the fact that new business creation itself has been a fraction of what it was in previous recoveries, these statistics show that large swaths of the United States have largely been left out of any economic upswing over the last decade. Congress and regulatory agencies must continue to be focused on pro-growth initiatives that help create and sustain wealth for households and communities all across the country.

Fortunately, action has already been taken this Congress that will help reverse these trends. The historic tax reform package signed by President Trump in December 2017 is already producing positive benefits for American households and businesses.<sup>2</sup> By lowering rates and making our tax system more globally competitive, business leaders are investing back in their businesses, rewarding their employees, and hiring more workers.

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<sup>1</sup> “The New Map of Economic Growth and Recovery” Economic Innovation Group, May 2016.

<sup>2</sup> See e.g. U.S. Chamber Tax Reform Map <https://www.uschamber.com/tax-reform>

Additionally, the House of Representatives is scheduled this week to vote on S. 2155, the “Economic Growth, Regulatory Relief, and Consumer Protection Act,” following Senate passage of the legislation in March. This legislation is the culmination of bipartisan work in both the House and Senate to move bank regulation away from the “one-size-fits-all” approach that has regrettably taken hold in the post-financial crisis era. S. 2155 will help small and regional banks better serve their communities around the country, and will ultimately contribute to stronger economic growth.

But we believe Congress should not merely rest on its laurels, and should continue to pursue pro-growth and pro-opportunity policies that help growing businesses access capital. The Financial Services Committee – as well as the full House of Representatives – has already passed dozens of bipartisan bills this Congress that we believe merit further action and should ultimately make it to the President’s desk before the end of this year. The Chamber strongly supports many of these bills and is optimistic that the House and Senate can work together to craft a bipartisan capital formation package.

The legislative proposals being discussed at today’s hearing also present opportunities to advance bipartisan legislation this Congress that will modernize the rules and regulations that apply to public companies in the United States.

#### **The Need to Modernize the Public Company Model**

The public company has been a key source of strength and growth which has helped make the United States economy the strongest and most prosperous in world history. When businesses go public, jobs are created and new centers of wealth are formed. A 2012 study done by the Kauffman Foundation found that for the 2,766 companies that went through the IPO process between 1996 and 2010, employment cumulatively across these business increased by 2.2 million jobs, while total revenue increased by over \$1 trillion.<sup>3</sup>

The public capital markets are also not static and help to support innovation. Only about 12% of the Fortune 500 companies in 1955 were still on the list in 2014, while the other 88% have either gone out of existence, merged with another company, or fallen out of the Fortune 500.<sup>4</sup> This system of creative destruction has forced businesses to change with the times, or be replaced by new entrants with innovative

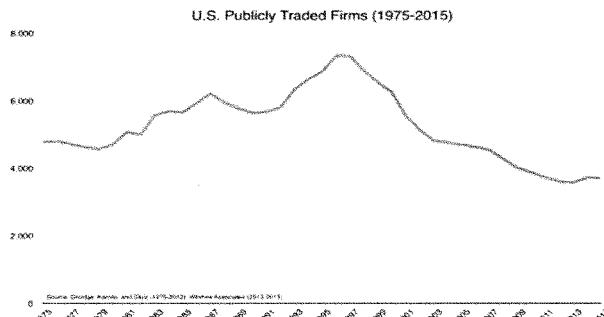
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<sup>3</sup> Post-IPO Employment and Revenue Growth for U.S. IPOs June 1996-2010  
<https://www.kauffman.org/what-we-do/research/2012/05/postipo-employment-and-revenue-growth-for-us-ipos-june-19962010>

<sup>4</sup> Mark Perry, AEIdeas, August 18, 2014

ideas and products that meet the needs of consumers and an ever-changing marketplace.

Regrettably, the public company model has become increasingly unattractive to businesses. In the 20 years from 1996-2016, the number of public companies in the United States dropped in 19 of those years. The one year where there was an increase is attributable to the passage of the Jumpstart our Business Startups Act (“JOBS Act”) that was spearheaded by this Subcommittee. To put it in even starker measures, an article last year by the Wall Street Journal pointed out that we have roughly the same number of public companies today as we did in 1982.<sup>5</sup> Since 1982, the United States population has grown by 40% and the real GDP has increased by 160%, yet the number of public companies has remained stagnant.



No one single event or regulation lies at the heart of the public company crisis. Like straw upon a camel's back, the burdens and reporting requirements associated with being a public company today have steadily accumulated over the years, to the point where many businesses are rejecting a model that was once the ultimate dream of American entrepreneurs. The JOBS Act was a great first step towards arresting this worrisome trend, and we have already seen tangible results from the law's implementation. For example, in 2013 – the first full calendar year after the JOBS Act was passed – 226 initial public offerings (IPOs) were listed in the United States (the

<sup>5</sup> “America’s Roster of Public Companies is Shrinking Before our Eyes” Wall Street Journal January 6, 2017

highest number since 2004), followed by 291 in 2014.<sup>6</sup> While the IPO market has since cooled, the vast majority of companies that are going public are doing so using provisions of the JOBS Act.

To help promote policy solutions that would build off the success of the JOBS Act, eight organizations – the American Securities Association, Biotechnology Innovation Organization, Equity Dealers of America, Nasdaq, National Venture Capital Association, Securities Industry and Financial Markets Association, TechNet, and the U.S. Chamber – recently released a report entitled *Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public*. This report includes 22 recommendations that encompass five general categories:

- 1) Enhancements to the JOBS Act;
- 2) Recommendations to encourage more research of emerging growth companies (EGCs) and other small public companies;
- 3) Improvements to certain corporate governance, disclosure, and other regulatory requirements;
- 4) Recommendations related to financial reporting and;
- 5) Recommendations related to equity market structure

The full report is included as an addendum to this testimony. While these eight organizations all represent different facets of the American economy, we all share a common concern that the decline in public companies presents serious long term growth and job creation challenges for the United States economy if it is left unaddressed. We appreciate that the Subcommittee has put forward a number of pieces of draft legislation that incorporate many of the recommendations in our report. Our comments on several of these measures are included below.

**H.R. 5756, to require the Securities and Exchange Commission to adjust certain resubmission thresholds for shareholder proposals**

H.R. 5756 would adjust the levels of support that a proposal from a public company shareholder must receive before it is resubmitted in a subsequent year. The current “resubmission rule” under Rule 14a-8 of the 1934 Securities Exchange Act allows a company to exclude a proposal from its proxy statement if it failed to receive the support of:

- 3% of shareholders the last time it was voted on (if voted on once in the past five years)

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<sup>6</sup> <https://www.sec.gov/info/smallbus/acsec/giovannetti-presentation-acsec 021517.pdf>

- 6% of shareholders the last time it was voted on (if voted on twice in the past five years)
- 10% of shareholders the last time it was voted on (if voted on three or more times in the past five years)

In other words, a shareholder proponent is able to continuously resubmit a proposal even if – in some instances – over 90% of shareholders have voted against it on more than one occasion. The shareholder proposal system under Rule 14a-8 was originally established as a means to facilitate communication between shareholders and management, and to ensure that shareholders maintained a voice in how a particular company was run. Over the years, however, the shareholder proposal system has devolved into a mechanism that special interests use to advance idiosyncratic agendas at the expense of other investors. To put this into perspective, according to the Manhattan Institute, during the 2016 proxy season fully *half* of all proposals submitted to Fortune 250 companies dealt with some type of social or public policy related matter – not issues fundamental to enhancing the long term value of public companies.<sup>7</sup> Not only does this misuse of the system cost shareholders in terms of legal and other fees, but it serves to distract management and company boards from focusing on long term strategy – both issues that can be particularly impactful to small or midsize public companies.

In 1997, the Securities and Exchange Commission (SEC) proposed a rule that would have changed the current 3%/6%/10% system to a more reasonable 6%/15%/30% system. Such modified thresholds would still allow eligible shareholders to submit proposals on various issues, however it would limit the number of times that the vast majority of shareholders would be forced to pay the costs in order to register their opposition. H.R. 5756 simply adopts what the SEC proposed in 1997, which we believe would properly balance the interest of issuers with ensuring that shareholders maintain their voice in corporate matters.

#### **H.R. 5054, the Small Company Disclosure Simplification Act of 2018**

This legislation would provide a temporary and optional exemption for small issuers from the eXtensible Business Reporting Language (XBRL) requirements administered by the SEC. While XBRL was created in order to move away from a paper-based system of financial disclosures, it remains a work in progress and has experienced a number of growing pains. As a result, it has proven to be yet another

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<sup>7</sup> An Annual Report on Corporate Governance and Shareholder Activism September 27, 2016 (J. Copland and M. O'Keefe)  
[https://www.manhattan-institute.org/sites/default/files/pmr\\_2016.pdf](https://www.manhattan-institute.org/sites/default/files/pmr_2016.pdf)

hurdle placed in front of growing business that are looking to gain access to America's robust capital markets.

H.R. 5054 would afford the SEC time to fix some of the deficiencies associated with XBRL. The optional exemption for EGCs and small issuers appropriately grants company boards and their shareholders the ultimate authority to decide whether or not using XBRL is in the best long term interest of the company. This is preferable to a top-down mandate from the SEC for issuers of all sizes to comply with a system that is clearly facing a number of short-term issues.

Furthermore, Congress made it clear when the JOBS Act was passed that the bifurcation of securities regulation can help promote capital formation for small companies. This is why Congress created an "on-ramp" in Title I of the JOBS Act and excluded EGCs from a number of onerous mandates that were inhibiting their ability to grow and create jobs. H.R. 5054 is consistent with this approach, and the Chamber supports its adoption.

**H.R. \_\_, to provide a five year extension of certain exemptions and reduced disclosure requirements for companies that were emerging growth companies and would continue to be emerging growth companies but for the five year restriction on emerging growth companies, and for other purposes.**

The Chamber strongly supports this draft legislation, which would simply extend many of the exemptions afforded to EGCs under the IPO "on-ramp" of Title I of the JOBS Act from five years to ten years. These exemptions include an allowance for confidential reviews of registration statements by SEC staff, simplified executive compensation disclosures, and exemptions from certain provisions under the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), including say on pay and say on frequency requirements, and the "pay ratio" disclosure mandate. The vast majority of EGCs have taken advantage of many of these exemptions, which have helped reduce reporting and compliance burdens without compromising important investor protections. As companies continue to mature five years after going public, extending these targeted exemptions to ten years would likely further incentivize businesses to go public in the first place. This is especially timely and critical as many companies that went public soon after the JOBS Act was passed are now reaching their five-year time limitation, and yet are still sensitive to becoming subject to full reporting requirements that are more appropriate for large, established issuers. Importantly, these exemptions would remain completely optional – companies would be free to begin reporting some of this information if they felt it was in the best interest of their shareholders and the long-term performance of the company.

**H.R.\_\_\_\_, to direct the Securities and Exchange Commission to revise Rule 163 under the 1933 Securities Act to apply the exemption offered in such section to communications made by underwriters and dealers acting by or on behalf of well-known seasoned issuers**

Well-known seasoned issuers, or “WKSIs,” are issuers that have a demonstrated reporting history with the SEC, meet certain market capitalization thresholds, and are generally widely followed in the marketplace. Because of this status, WKSIs are under certain conditions permitted to engage in oral or written communications with potential investors without violating the “gum jumping” provisions of the 1933 Securities Act. In 2009, the SEC proposed allowing underwriters or dealers to engage in such communications on behalf of WKSIs.<sup>8</sup> While current rules allow issuers to engage in pre-filing communications, underwriters are often best positioned to “test the waters” prior to an offering. Allowing WKSIs to authorize an underwriter or dealer to communicate about offerings of the issuer’s securities prior to the filing of a registration statement would help these companies better gauge investor interest before having to expand the time and resources to file a formal registration statement. While the SEC’s response to the financial crisis overtook Rule 163 reform as a priority and the 2009 proposal was never finalized, we believe this remains an important initiative that will help issuers raise capital. The Chamber strongly supports the draft legislation, which would simply codify into statute the SEC’s 2009 proposal.

**H.R.\_\_\_\_, to direct the Securities and Exchange Commission to conduct a study with respect to research coverage of small issuers before their initial public offerings, and for other purposes**

One major issue that has developed in the public capital markets over the last two decades is a steady decrease in the level of analyst coverage of small public companies. According to Capital IQ, 61% of all companies listed on a major exchange with less than a \$100 million market capitalization have no research coverage at all. Notwithstanding provisions of the JOBS Act intended to increase research, EGCs and other small issuers still have trouble obtaining analyst coverage today. The draft legislation would simply direct the SEC to conduct a long-overdue study on this issue and to develop recommendations on how to increase the amount of research that is conducted on small public companies. The bill would require the SEC to examine its own rulebook, as well as that of the Financial Industry Regulatory Authority (FINRA), state and federal liability concerns, the 2003 Global Research

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<sup>8</sup> Release No. 33-9098 Revisions to Rule 163, 74 Fed. Reg. 68545 (December 28, 2009).

Analyst Settlement, and the Markets in Financial Instruments Directive (MiFID II). The Chamber supports this legislation, which will help the public better understand how current regulations may be restricting the flow of information to investors regarding small issuers. The bill should also produce helpful recommendations that Congress or the SEC can act upon in the future.

**H.R.\_\_\_\_, to remove the limitation on large accelerated filers qualifying as an emerging growth company, and for other purposes**

The Chamber supports this draft legislation which would remove the counterproductive “phase out” rules which cause a great deal of uncertainty regarding EGC status for public companies. Under the JOBS Act, an issuer will cease to be an EGC if they happen to cross the public float threshold that constitutes a “large accelerated filer” under Securities Exchange Act Rule 12b-2. Thus a company that happens to be highly valued in the market – but which may have revenues that fall well below the EGC threshold of \$1 billion per year – could lose their EGC status and many of the regulatory exemptions that come with it. In 2014, for example, some 30% of EGCs that went public in 2012 complied with the internal controls requirements of Sarbanes Oxley Section 404(b) because they became large accelerated filers.<sup>9</sup> Importantly, the draft bill also grants the SEC the authority to establish a public float threshold (above the current \$700 million, which constitutes a large accelerated filer) that a company would have to trigger before losing status as an EGC. This would help ensure that EGC status is reserved only for smaller public companies.

**H.R.\_\_\_\_, to require the Securities and Exchange Commission to revise the definition of a qualifying portfolio company to include an emerging growth company, for purposes of the exemption from registration for venture capital fund advisers under the Investment Advisers Act of 1940**

The Dodd-Frank Act included an exemption for certain venture capital funds from a requirement to register as a registered investment adviser (RIA). However, the SEC’s implementing regulation for this exemption provided for a definition of a venture capital fund that was unnecessarily narrow and failed to take into account many aspects of the venture capital industry. For example, many growth equity funds – which often times are large investors in EGCs and other small companies – are left out of the definition of a venture capital fund. The Chamber supports the draft legislation, which would allow shares of EGCs to be considered “qualifying investments” for purposes of RIA exemption determinations. This would allow

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<sup>9</sup> The JOBS Act, Two Years Later: An Updated Look at the IPO Landscape. Latham & Watkins April 5, 2014

growth equity and other venture capital funds to continue to play a critical role in providing capital to EGCs around the time they are considering an IPO.

**H.R.\_\_\_\_, to increase the threshold for mutual funds before triggering diversified fund limits from ten percent of voting shares to fifteen percent**

The Chamber supports this draft legislation which would modestly increase the amount that a mutual fund could hold in a single security and still maintain status as a “diversified” fund. Currently, mutual funds qualify as diversified under the Investment Company Act of 1940 if they hold no more than 5% of their assets in any single company, or 10% of the voting shares in a company. Mutual funds provide an important source of capital and liquidity for the shares of EGCs and small companies, however the 10% limit on an investment in a single company constrains the ability of funds to provide this capital. As explained in a 2017 paper on small IPOs, “As a diversified fund’s [assets under management] grows, efforts to deploy new fund flows into a small issuer will increasingly be constrained by this 10% position limit, meaning a large fund’s investment in the company will represent a diminishing fraction of the fund’s AUM.”<sup>10</sup> We believe that modestly increasing this threshold from 10% to 15% will allow diversified mutual funds to continue to invest in EGCs or small issuers even as their assets under management continue to grow.

**H.R.\_\_\_\_, the Streamlining Disclosure Options to Reduce Redundant Disclosures to Investors Act**

Over the decades since the securities laws were enacted, and especially in more recent years, the disclosure documents that companies file with the SEC have continued to expand, as reflected by the lengthy annual and quarterly reports, as well as proxy statements provided to investors. As many have pointed out, disclosure documents are laden with much information that is obsolete, unnecessarily repetitive, or otherwise not useful to investors. This problem can be especially acute for EGCs and small public companies, which often times don’t have the same level of compliance resources as large established companies, and can be especially burdened by our outdated disclosure regime. According to the 2011 report of the IPO Task Force, 92% of public company CEOs stated that the “administrative burden of public reporting” was a significant challenge to completing an IPO and becoming a public company.<sup>11</sup>

<sup>10</sup> The Small IPO and Investment Preferences of Mutual Funds (Robert Bartlett III, Paul Rose, Steven Davidoff Solomon) July 28, 2017 at 9.  
Available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2718862](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2718862)

<sup>11</sup> Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth  
Available at: [https://www.sec.gov/info/smallbus/acsec/rebuilding\\_the\\_ipo\\_on-ramp.pdf](https://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf)

This draft legislation, which the Chamber strongly supports, would simply give issuers the option of reporting quarterly information in a different format than is currently required by Form 10-Q. For example, issuers could distribute a press release that contains quarterly financial results – which would provide investors with important information – instead of the lengthier 10-Q that often times contains repetitive information that has already been disclosed. Importantly, issuers would still be required to notify investors of any significant events through Form 8-K, so the legislation would not deprive shareholders or the public of material information that is critical for investment and voting decisions.

**H.R.\_\_\_\_, the Main Street Growth Act**

The Chamber also supports this draft legislation circulated by Rep. Emmer, which would establish the legal framework for the creation of “venture exchanges.” There is little doubt that investors have benefited from many of the technological and other changes in our equity markets over the last two decades, which have helped reduce trading costs, increased liquidity, and made markets more efficient. However, many of these benefits have not been distributed evenly across the equity markets. The trading environment for many small and midsize public companies – including EGCs – remains less liquid and fragmented as compared to the overall equity market. We believe that policymakers should move away from a “one size fits all” regulatory model and tailor market structure to help boost the trading of EGCs and other small issuers.

While the JOBS Act did a great deal to help EGCs raise capital in primary offerings, it did comparatively little to address the secondary market trading in these companies. The Main Street Growth Act seeks to remedy this issue by providing a tailored trading platform for EGCs and stocks with distressed liquidity. Companies that choose to list on a venture exchange would have their shares traded on a single venue, thereby concentrating liquidity and exempting these shares from rules that are more appropriate for deeply liquid and highly valued stocks. Venture exchanges would also be afforded the flexibility to develop intelligent “tick sizes” that could help incentivize market makers to trade in the shares of companies listed on the exchange. Importantly, both the creation of the venture exchange and the decision to list on such an exchange are completely optional – the bill would not mandate that companies that meet certain criteria trade on a venture exchange. We believe this legislation is an important step towards properly tailoring market structure rules for small issuers.

**Conclusion**

We appreciate the work of the Capital Markets, Securities, and Investment Subcommittee on these important bills and issues. The Chamber is prepared to work with the Subcommittee on a bipartisan basis to achieve many of these reforms that would modernize the public company regulatory regime in the United States. We must be successful in these efforts to spur economic growth that stimulates investment and creates good paying jobs.



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June 4, 2018

The Honorable Bill Huizenga  
 Chairman  
 Subcommittee on Capital Markets,  
 Securities, and Investment  
 Committee on Financial Services  
 United States House of Representatives  
 Washington, D.C. 20515

The Honorable Carolyn B. Maloney  
 Ranking Member  
 Subcommittee on Capital Markets,  
 Securities, and Investment  
 Committee on Financial Services  
 United States House of Representatives  
 Washington, D.C. 20515

Dear Chairman Huizenga and Ranking Member Maloney:

Subject: May 23, 2018 Hearing Entitled "Legislative Proposals to Help Fuel Capital and Growth on Main Street"

On behalf of the California Public Employees' Retirement System ("CalPERS"), I write to respectfully express our views about several issues that were considered during the Capital Markets, Securities, and Investment Subcommittee hearing on May 23, 2018, entitled "Legislative Proposals to Help Fuel Capital and Growth on Main Street."<sup>1</sup> We respectfully request that this letter be included in the hearing record.

CalPERS is the largest public, defined benefit pension fund in the United States, with \$351.80 billion in global assets, as of market close May 29, 2018, and equity holdings exceeding 10,000 companies. CalPERS manages investment assets on behalf of more than 1.9 million California public employees, retirees and beneficiaries. As a global, institutional investor with a long-term investment horizon, CalPERS depends on the integrity, transparency and efficiency of the financial markets, as well as access to reliable and accurate information in order to make investment decisions. The investment objective of CalPERS is to provide long-term sustainable, risk-adjusted returns.

We appreciate the Subcommittee's consideration of a number of legislative proposals that are designed to address regulatory impediments that impact the ability of "Main Street" businesses, early-stage and small companies, as well as emerging growth companies ("EGCs"), to access capital, which is vitally important to business and productivity growth, job and wealth creation, sustainable community and economic development, and innovation. CalPERS provides this much-needed capital by investing in public companies, primarily as a long-term investor. The benefits of access to capital accrue to the direct recipients of investments and to the geographic areas in which they are located. As such,

<sup>1</sup> House Financial Services Committee, Hearings,  
<https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=403426>.

The Honorable Bill Huizenga and The Honorable Carolyn B. Maloney  
 United States House of Representatives  
 June 4, 2018  
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we have long supported efforts to promote capital formation and more liquid financial markets to spur sustainable growth in the real economy, while at the same time fostering greater transparency and protecting investor rights.

As the Subcommittee considers efforts to stimulate capital formation, particularly for small and medium sized enterprises, we respectfully urge you to also consider the potential implications of these initiatives for an investor such as CalPERS, as well as other providers of capital. In this regard, we would like to take this opportunity to provide our views about the following topics: corporate governance; potential enhancements of the Jumpstart Our Business Startups ("JOBS") Act; the need for additional research on EGCs and smaller issuers; corporate financial reporting; and equity market structure reform.

**Corporate Governance:**

As embodied in the CalPERS Governance & Sustainability Principles (the "Principles"),<sup>2</sup> we firmly embrace accountable corporate governance. In CalPERS' experience, it is critical for capital providers, particularly institutional investors, to have the ability to actively engage with company management, and the shareholder proposal process promotes such engagement. For this reason, we are opposed to efforts to substantially revise the resubmission thresholds for shareholder proposals under Securities and Exchange Commission ("SEC") Rule 14a-8. Because large companies comprise a larger portion of investors' equity portfolios than small companies, large companies are more likely to receive shareholder proposals. According to the ISS Voting Analytics database, S&P 500 companies received some 659 proposals in 2017, which equaled 77 percent of the 852 proposals that Russell 3000 companies received and corresponded to the S&P's coverage of the Russell 3000's market capitalization. Of particular note, only 3.7 percent of shareholder proposals in the ISS database were filed at companies with a market capitalization below \$1 billion.

Given the small number of shareholder proposals that are filed at reporting companies in the U.S. with the overwhelming majority being filed at S&P 500 companies, it appears as though there is no shareholder proposal crisis at small companies that needs to be addressed. Historically, small shareholders initiated many of the campaigns for enhancements at large companies that were eventually adopted as best corporate practices. There is no need to restrict shareholder proposals, which would make it more difficult for shareholders to file proposals and have them appear in proxies. Therefore, we oppose efforts to prevent or further restrict shareholders from exercising their rights as owners. We emphasize that this is not a matter of "shareholder activism." Rather, shareholder engagement is critical to the exercise of our fiduciary responsibilities and to the pursuit of our aforementioned investment objectives.

We oppose efforts that would establish a burdensome regulatory regime for proxy advisory firms or grant issuers undue influence over the proxy recommendation process. The

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<sup>2</sup> CalPERS Governance & Sustainability Principles, Apr. 17, 2017,  
<https://www.calpers.ca.gov/docs/forms-publications/governance-and-sustainability-principles.pdf>.

The Honorable Bill Huizenga and The Honorable Carolyn B. Maloney  
United States House of Representatives  
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proposed changes would force institutional investors to pay significantly more to comply with our fiduciary obligations to vote our shares. We have heard the concerns about perceived "conflicts of interest" in the proxy advisory industry, but have not seen credible examples. We are concerned about imposing conflict of interest management requirements when existing SEC requirements appear to be effective in this area. Among other things, we are also concerned that proposed reforms would present additional barriers to entry for new proxy advisory firms rather than enhance competition. Proxy advisory firms and other data providers play a useful role in efficiently providing institutional investors with independent research and analysis to help us execute our voting decisions. Accordingly, we oppose efforts to subject proxy advisory firms to new, duplicative and overly burdensome regulatory requirements.

We support the current quarterly filing regime. Certain 8-K filings are no substitute for 10-Qs. Although an argument can be made that people trade on the 8-Ks, such an argument holds simply because the 8-Ks are released prior to 10-Q filings. The 10-Qs provide substantial and important information and serve as a great historical resource. Any modification of standard quarterly filings should be preceded by significant study with ample opportunity for investor input.

These views are consistent with the underlying tenet of the Principles: fully accountable governance structures produce, over the long term, the best returns to shareowners.

**Enhancements to the JOBS Act:**

The JOBS Act provides a number of benefits to EGCs, including those related to the submission of confidential registration statements to the SEC, as well as scaled disclosures concerning executive compensation and audited financial statements. As a significant capital provider, we believe that the current five-year exemption for EGC status is a well thought out compromise, given that many institutional investors were against any exemption in the first place. Further, we are only aware of anecdotal evidence that an extension of the exemption for EGC status would benefit certain companies, and we have seen no convincing evidence that there would be a market benefit to such extension. Large accelerated filers have large market capitalizations and should report accordingly. To be clear, the proposal would provide exemptions to very low revenue producing (but highly valued) companies while forcing companies with more substantial revenues to continue to comply with standard reporting. It appears that the wrong market behavior would be rewarded if the proposed exemption is given to low revenue producing companies with high market capitalizations.

**Additional Research on EGCs and Other Small Public Companies:**

We favor proposals that are designed to promote additional research and coverage of small companies, and we support enabling the SEC to examine why pre-IPO research has not materialized following enactment of the JOBS Act. We note that the findings of these studies would help to inform and guide additional proposals and increase the likelihood of success for small publicly-traded companies.

The Honorable Bill Huizenga and The Honorable Carolyn B. Maloney  
United States House of Representatives  
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**Corporate Financial Reporting:**

Any proposals that would broaden eligibility for definition of a "smaller reporting company" ("SRC") should take into consideration (and should be balanced against) the critical information needs of investors. An SRC currently qualifies as such if it has a public float of less than \$75 million. We have long felt that financial reporting disclosures need to be meaningful, understandable, timely, comparable, and consistent to enable open and honest dialogue as well as informed decision-making. Consequently, any proposal to expand the number of registrants that qualify as SRCs must be consistent with the aforementioned principles in order to ensure investor protection.

**Equity Market Structure:**

CalPERS has consistently supported efforts to make reasonable reforms to the U.S. equity markets, and believes that such initiatives should mitigate risks to the markets and advance the interests of long-term investors. In recent history, technological advancements and regulatory actions have sought to increase market competition and lower trading costs. Unfortunately, this has resulted in increased market complexity and various unintended consequences, and long-term investors have often borne the cost. We note that proposals to improve liquidity and market quality by increasing the ticket sizes of EGCs and small capitalization stocks have raised important concerns about trading activity and volatility. CalPERS believes that such proposals should be carefully examined to assure that they are constructed in a manner that maximizes their utility while at the same time diminishes costs and risks to investors.

Thank you for considering our views. We welcome the opportunity to work with you on ways to protect investors while fostering a favorable regulatory environment for "Main Street" businesses and smaller companies so that they are able to access capital, innovate, grow and create jobs. Please do not hesitate to contact Gretchen Zeagler, Assistant Division Chief of Federal Policy at (916) 795-2911, if we can be of any assistance.

Sincerely,



MARCIE FROST  
Chief Executive Officer



May 23, 2018

Chairman Huizenga and Ranking Member Maloney,

The Equity Dealers of America (EDA) appreciates and thanks you for the opportunity to submit testimony to the House Financial Services Committee, Subcommittee on Capital Markets, Securities and Investments regarding “Legislative Proposals to Help Fuel Capital and Growth on Main Street”. We **strongly support** the committee’s efforts to promote capital formation and to advance each of the bills that will be discussed at today’s hearing.

The EDA is a trade association that represents the retail and institutional equity capital markets interests of middle-market financial services firms who provide Main Street businesses with access to capital and advise hardworking Americans how to create and preserve wealth. The EDA’s mission is to promote trust and confidence in the U.S. capital markets. We support efficient and competitively balanced equity capital markets that advance financial independence, stimulate job creation, and increase prosperity. The EDA’s membership base is geographically diverse in that it spans the Heartland, Southwest, Southeast, Atlantic, and Pacific Northwest regions of the United States.

EDA members act as important intermediaries who facilitate the flow of capital from those who have it, to those who need it. Those who need it are small and mid-size businesses located across America in every sector of the economy. These businesses represent the spirit of the American entrepreneur, they create jobs, and they stimulate economic growth. We support any effort to improve the environment for small businesses to access capital.<sup>1</sup>

Increasing the number of public companies also benefits retail investors, who, as the number of public companies has declined, have had fewer and fewer options to choose from. The policies discussed in today’s bills encourage companies to go public much earlier in their life cycle. This should serve to expand the pool of available investment options for investors and afford them with the opportunity to participate in the early stages of a public company’s growth cycle.

This committee passed the JOBS Act in 2012 and, while it was a step in the right direction, more can be done. Today’s hearing will focus on several bills which reflect concrete policy recommendations put forth by a very diverse group of market participants.<sup>2</sup> The goal of these

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<sup>1</sup> <https://www.investors.com/politics/commentary/how-to-promote-small-business-jobs-and-protect-investors/>

<sup>2</sup> [http://equitydealers.org/wp-content/uploads/IPO-Report\\_EXPANDING-THE-ON-RAMP.pdf](http://equitydealers.org/wp-content/uploads/IPO-Report_EXPANDING-THE-ON-RAMP.pdf)

policies is to improve the environment for small businesses to go public and stay public. There is no single magic bullet. None of the policy recommendations alone will solve the problem; adopting **ALL** of the policies in today's bills is necessary to change the regulatory environment and market structure for small businesses. Only then, will they have the chance to thrive as public companies.

Thank you for your attention to this very important issue and please let me know how the EDA can continue to support the Committee's initiatives on small business capital formation.

Christopher A. Iacovella  
Chief Executive Officer  
Equity Dealers of America



Via Hand Delivery

May 22, 2018

The Honorable Bill Huizenga  
 Chairman  
 Subcommittee on Capital Markets, Securities, and Investment  
 Committee on Financial Services  
 United States House of Representatives  
 Washington, DC 20515

The Honorable Carolyn B. Maloney  
 Ranking Member  
 Subcommittee on Capital Markets, Securities, and Investment  
 Committee on Financial Services  
 United States House of Representatives  
 Washington, DC 20515

*Re: May 23, 2018, hearing entitled "Legislative Proposals to Help Fuel Capital and Growth on Main Street"*

Dear Mr. Chairman and Ranking Member Maloney:

I am writing on behalf of the Council of Institutional Investors (CII), a nonpartisan, nonprofit association of public, corporate, and union employee benefit funds, other employee benefit plans, foundations, and endowments with combined assets under management exceeding \$3.5 trillion. Our member funds include major long-term shareholders with a duty to protect the retirement savings of millions of workers and their families.

Our associate members include a range of asset managers with more than \$25 trillion in assets under management, most also with long-term investment horizons. CII members share a commitment to healthy public capital markets and strong corporate governance.<sup>2</sup>

The purpose of this letter is to thank you for holding the above referenced hearing and to share with you some of our views on this important topic.<sup>3</sup> We would respectfully request that this letter be included in the hearing record.

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<sup>1</sup> Financial Services Committee, Hearings, <https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=403426>.

<sup>2</sup> For more information about the Council of Institutional Investors (CII) and our members, please visit CII's website at [http://www.cii.org/about\\_us](http://www.cii.org/about_us).

<sup>3</sup> See Memorandum from FSC Majority Staff to Members of the Committee on Financial Services 1 (May 18, 2018), [https://financialservices.house.gov/uploadedfiles/052318\\_cm\\_memo.pdf](https://financialservices.house.gov/uploadedfiles/052318_cm_memo.pdf).

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Status of the U.S. Public Capital Markets

We believe that the U.S. public capital markets are fundamentally healthy and remain the preferred choice for businesses to seek capital, notwithstanding more robust private markets and access to capital through non-U.S. public markets.<sup>4</sup> And the volume of initial public offerings is on the rise.<sup>5</sup>

The decline in the number of U.S. public companies since the peak of 20 years ago has not in our view significantly diminished the ability of U.S. businesses to obtain capital. We note that key factors in the decline in the number of public companies has been the corresponding growth in the private markets and the related increase in mergers and acquisitions (M&A) activity.

*Growth in private markets*

Compared to just 15 years ago, companies have many more ways to access significant capital without utilizing the public markets.<sup>6</sup> Venture capitalists, private equity firms, and sovereign funds have considerable capital to invest in private companies.

For example, between 2008 and 2014, while public capital-raising hovered around \$250 billion per year, private capital-raising increased from about \$700 billion in 2008 to more than \$1.25 trillion in 2014.<sup>7</sup> Given the various choices U.S. businesses have for funding, many have chosen to remain private longer.

The U.S. Congress has incentivized businesses to remain private longer, including when it increased the accredited investor limit for registering with the U.S. Securities and Exchange Commission (SEC or Commission) from 500 to 2,000 in the Jumpstart Our Business Startups Act of 2012.<sup>8</sup> The result is that U.S. businesses that move to a public offering in recent years have tended to be more mature and have more solid business prospects, in contrast to the prior boom cycles.<sup>9</sup>

<sup>4</sup> See, e.g., EY, "Looking Behind the Declining Number of Public Companies, An Analysis of Trends in US Capital Markets" 15 ("In our view, US public capital markets are fundamentally healthy and remain the preferred choice for U.S. and many foreign companies that seek to go public."), <http://www.ey.com/Publication/wcl/Assets/an-analysis-of-trends-in-the-us-capital-markets-15-ey-an-analysis-of-trends-in-the-us-capital-markets.pdf>.

<sup>5</sup> Nasdaq, "Progress in Process, Update on Nasdaq's Blueprint to Revitalize Capital Markets" 3 (May 2018), [http://business.nasdaq.com/media/Nasdaq\\_Revitalize\\_Progress\\_Report\\_May\\_2018\\_tcm5044-61462.pdf](http://business.nasdaq.com/media/Nasdaq_Revitalize_Progress_Report_May_2018_tcm5044-61462.pdf).

<sup>6</sup> EY at 8-10 ("The private capital market has grown aggressively recently, allowing emerging companies to access more capital without going public.").

<sup>7</sup> See Scott Baugess et al., "Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offering 2009-2014," at 7 (Oct. 1, 2015), <https://www.sec.gov/files/unregistered-offering10-2015.pdf>.

<sup>8</sup> See, e.g., Elisabeth De Fontenay, "The Deregulation of Private Capital and the Decline of the Public Company," 68 Hastings L.J. 445, 468-69 (Mar. 29, 2017) ("By increasing the shareholder cap from 500 to 2000, Congress enables extraordinarily large private companies whose stock is widely held by passive investors to avoid becoming public companies."), available at <https://www.sec.gov/spotlight/investor-advisory-s-2012/elisabeth-de-fontenay-deregulation-private-capital.pdf>.

<sup>9</sup> See EY at 1 ("Growth companies choosing to sell shares to the public today are typically stable and have solid prospects for growth.").

*Growth in M&A activity*

A second key and related factor in the decline in the number of public companies has been the increase in M&A activity. From 1997 to 2012 the percentage of public companies delisted for cause did not increase, but the percentage of firms delisted because of a merger did.<sup>10</sup> Moreover, since 2000, leveraged buyouts by private equity firms have surged, accounting for 9% of delistings of public companies, including almost one-quarter of all delistings in 2006.<sup>11</sup>

The increase in the number of leveraged buyouts in recent years is not surprising given the corresponding growth in the private equity firm industry.<sup>12</sup> In 1980, there were only 24 private equity firms and deal volume only modestly exceeded \$1 billion.<sup>13</sup> Today there are more than 3,000 U.S. private equity firms and assets under management for buyout funds of roughly \$825 billion, up from \$80 billion in 1996 and less than \$1 billion in 1976.<sup>14</sup>

Finally, significant U.S. private companies have been acquired before they can become public at a rapid pace in recent years, with the 2014-16 average for acquisitions in excess of \$100 million exceeding any previous three-year period in recent decades.<sup>15</sup>

Corporate Governance

CII has long held that good corporate governance—defined to include market transparency, integrity and accountability and specific relationships between boards, management and shareowners—is in the best long-term interests of shareowners and the U.S. capital markets.<sup>16</sup>

We believe that shareowners, other investors and other stakeholders benefit when rules and regulations provide adequate protections to owners and ensure that important information is promptly and transparently provided to the marketplace.<sup>17</sup>

The value of good governance structures/practices within public companies—such as substantially independent boards, all-independent key committees and other board accountability policies/practices—is backed by commonsense and experience. Such structures and practices ensure that directors have the necessary independence from management to, among other things, monitor and assess corporate performance; select, monitor, evaluate and, when necessary, fire the chief executive and other senior managers; oversee management succession; and structure,

<sup>10</sup> Craig Doidge et al., “The U.S. Listing Gap,” 123 J. Fin. Econ. 464, 465-66 (Mar. 2017), available at <https://www.sciencedirect.com/science/article/pii/S0304405X1630232X> (purchase required).

<sup>11</sup> Michael J. Mauboussin et al., Credit Suisse, “The Incredible Shrinking Universe of Stocks, The Causes and Consequences of Fewer U.S. Equities” 7 (Mar. 22, 2017), [https://www.cmgwealth.com/wp-content/uploads/2017/03/document\\_107275361.pdf](https://www.cmgwealth.com/wp-content/uploads/2017/03/document_107275361.pdf).

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> EY at 14.

<sup>16</sup> CII, Policies on Other Issues, Value of Corporate Governance, [http://www.cii.org/policies\\_other\\_issues#value\\_corp\\_gov](http://www.cii.org/policies_other_issues#value_corp_gov).

<sup>17</sup> *Id.*

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monitor and approve compensation paid to the chief executive and other senior managers. They also ensure that directors are accountable to shareowners.

We are unaware of any evidence of a causal connection between federally imposed improvements to corporate governance and the decline in the number U.S. public businesses.<sup>18</sup> We offer the following summary discussion of CII views on specific issues addressed by three of the eleven bills and discussion drafts to be examined by the Subcommittee at the hearing. In each case, we believe the proposed legislation, if enacted, would be inconsistent with improving corporate governance in the U.S. capital markets.

*1. Extensible Business Reporting Language (XBRL)*

CII has long supported expanded use of data tagging to facilitate more accurate and less costly extraction and use of data in public company filings.<sup>19</sup> We agree with SEC Commissioner Kara Stein that machine readable data, including data that can result from XBRL tagging requirements, allows users to select only those data elements they want and present it in a format they find useful, regardless of the particular format used by registrants.<sup>20</sup> Given the various audiences for disclosure and the increasing diversity of investor strategies, such customization makes disclosure documents—both individually and across registrants more usable.<sup>21</sup> As a result, we believe many investors place a significant value on having required SEC disclosures subject to XBRL tagging requirements.<sup>22</sup>

*H.R. 5054<sup>23</sup>*

H.R. 5054 would require the Commission to amend its regulations to exempt certain issuers from the requirements to format their SEC filings using machine readable XBRL. The bill would create (1) a permanent exemption for companies qualifying as “emerging growth companies,”

<sup>18</sup> See Michael J. Mauboussin et al. at 20 (“the shrinkage in the population of listed companies started well before . . . [Sarbanes-Oxley Act] was implemented”); see also Office of Investor Advocate, U.S. Securities and Exchange Commission, Report on Objectives 6 (2018) (“recent academic studies demonstrate that it is difficult to establish any causal connection between disclosure mandates and IPO activity”), <https://www.sec.gov/files/sec-office-investor-advocate-report-on-objectives-fy2018.pdf>; Elisabeth De Fontenay at 448 (“even if public company disclosure requirements had remained constant over the last three decades, there would likely still be a dearth of public companies today, due to the increasing ease of raising capital privately”).

<sup>19</sup> See, e.g., Letter from Kenneth A. Bertsch, Executive Director, Council of Institutional Investors, to Brent J. Fields, Secretary, U.S. Securities and Exchange Commission 3 (July 8, 2016), [https://www.cii.org/files/issues\\_and\\_advocacy/correspondence/2016/07\\_08\\_16%20CII%20S-K.pdf](https://www.cii.org/files/issues_and_advocacy/correspondence/2016/07_08_16%20CII%20S-K.pdf).

<sup>20</sup> See Commissioner Kara M. Stein, “Disclosure in the Digital Age: Time for a New Revolution,” speech before the 48th Annual Rocky Mountain Securities Conference 3 (May 6, 2016) (machine readability data “allows data to be pulled out of filings and presented according to the needs of consumers”), <https://www.sec.gov/news/speech/speech-stein-05062016.html>.

<sup>21</sup> Letter from Kenneth A. Bertsch at 3.

<sup>22</sup> Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors, to Brent J. Fields, Secretary Securities and Exchange Commission 4 (Sept. 22, 2016), [https://www.cii.org/files/issues\\_and\\_advocacy/correspondence/2016/September%202016%20comment%20letter%20final%20with%20letterhead%20KAB.pdf](https://www.cii.org/files/issues_and_advocacy/correspondence/2016/September%202016%20comment%20letter%20final%20with%20letterhead%20KAB.pdf).

<sup>23</sup> H.R. 5054, 115<sup>th</sup> Cong. (Feb. 15, 2018), <https://financialservices.house.gov/uploadedfiles/bills-115hr5054ih.pdf>.

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and (2) a temporary exemption for companies with less than \$250 million in annual gross revenue.<sup>24</sup>

It is our understanding that if H.R. 5054 were enacted more than 60 percent of public companies would likely be exempt from XBRL tagging requirements.<sup>25</sup> We agree with the SEC's Investor Advocate Rick Fleming that exempting such a large percentage of public companies "would seriously impede the ability of the SEC to bring disclosure into the 21<sup>st</sup> Century" and, in our view, would lessen the value and usefulness to investors of the data provided in public company filings.<sup>26</sup> We look forward to the SEC's adoption of final rules on its "inline XBRL" proposal that is expected to further reduce company costs for XBRL tagging going forward.<sup>27</sup>

## 2. Shareholder Proposals

CII and its members have a deep interest in ensuring that Rule 14a-8,<sup>28</sup> the federal rule that governs shareholder proposals, is a fair and workable standard shareowners and companies.<sup>29</sup> The rule provides an orderly means to mediate differences between managers and owners.

We are mindful that many positive advances in U.S. corporate governance practices simply would not have occurred without a robust shareowner proposal process in place. For example:

- Shareholder proposals were the impetus behind the now practice—currently mandated by major U.S. stock exchanges' listing standards—that independent directors constitute at least a majority of the board, and that all the members of the following board committees are independent: audit, compensation, nominating and corporate governance. Similarly, the concept of independent board leadership, now prevalent at U.S. companies through independent lead directors or independent

<sup>24</sup> *Id.* at § 2.

<sup>25</sup> See Daniel Castro et al., "Congress Should Not Undo Progress on Financial Data Reform," Hill, Feb. 11, 2015, at 1 (reporting that "data reporting exemptions . . . [in predecessor bill to H.R. 5054] would apply to 61 percent of public companies, and thus a massive amount of financial data would be lost as a public resource"), <http://rik.thehill.com/blogs/pundits-blog/finance/323417-congress-should-not-undo-progress-on-financial-data-reform>.

<sup>26</sup> Rick A. Fleming, Investor Advocate, "Effective Disclosure for the 21<sup>st</sup> Century Investor" 2 (Feb. 20, 2015) (commenting on Title VII of H.R. 37, the "Promoting Job Creation and Reducing Small Business Burdens Act"), <http://www.lexissecuritiesmosaic.com/gateway/sec/Speech/022015-spchrfr.html.htm>.

<sup>27</sup> Inline XBRL Filing of Tagged Data, Securities Act Release No. 10,323, Exchange Act Release No. 80,133, Investment Company Act Release No. 32,518, 82 Fed. Reg. 14,282, 14,283 (proposed rule Mar. 17, 2017) (proposed amendments intended to decrease "filing costs by decreasing XBRL preparation costs"), <https://www.gpo.gov/fdsys/pkg/FR-2017-03-17/pdf/2017-04366.pdf>.

<sup>28</sup> 17 CFR 240.14a-8 (Sept. 16, 2010), available at <https://www.law.cornell.edu/cfr/text/17/240.14a-8>.

<sup>29</sup> See, e.g., "Examining the U.S. Proxy Voting System: Is it Working for Everyone," Corporate Governance Roundtable, Hosted by Rep. Scott Garrett, 114<sup>th</sup> Cong 7 (Nov. 16, 2015) (Statement of Amy Borrus, Interim Executive Director, Council of Institutional Investors), [http://www.cii.org/files/issues\\_and\\_advocacy/2015/11\\_16\\_15\\_cii\\_Rep%20\\_Garrett\\_roundtable\\_submission\\_amy\\_borrus.pdf](http://www.cii.org/files/issues_and_advocacy/2015/11_16_15_cii_Rep%20_Garrett_roundtable_submission_amy_borrus.pdf).

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chairs, was pressed by investors in the 1990s mainly through shareholder proposals.<sup>30</sup>

- In 1987, an average of 16% of shareholders voted in favor of shareholder proposals to declassify boards of directors so that directors stand for election each year. In 2012, these proposals enjoyed an 81% level of support on average. Ten years ago, less than 40% of S&P 500 companies held annual director elections compared to more than two thirds of these companies today.<sup>31</sup>
- Electing directors in uncontested elections by majority (rather than plurality) vote was considered a radical idea a decade ago when shareholders pressed for it in proposals they filed with numerous companies. Today, 90% of large-cap U.S. companies elect directors by majority vote, largely as a result of robust shareholder support for majority voting proposals.<sup>32</sup>
- A proposal that built momentum even more rapidly and influenced the practices of hundreds of companies in the last few years is the request for proxy access. Resolutions filed by the New York City Comptroller to allow shareholders meeting certain eligibility requirements to nominate directors on the company's proxy ballot achieved majority votes at numerous companies. As a result, since 2015, more than 400 public companies have adopted proxy access bylaws.<sup>33</sup>

*Benefits to Companies*

The cost to companies of the existing shareholder proposal process is generally low and the process often results in benefits to companies.<sup>34</sup> It is important to note that most companies receive few, if any, shareholder proposals.<sup>35</sup>

<sup>30</sup> IRRC Corporate Governance Bulletin, "Independence of Directors Emerges as Major 1993 Issue," Investor Responsibility Research Center, November/December 1992 (on file with CII).

<sup>31</sup> See Ceres et al., "The Business Case for the Current SEC Shareholder Proposal Process" 6 (Apr. 2017), [https://www.issif.org/files/Public\\_Policy/Comment\\_Letter/Business%20Case%20for%2014a-8.pdf](https://www.issif.org/files/Public_Policy/Comment_Letter/Business%20Case%20for%2014a-8.pdf).

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*; see also Letter from Thomas P. DiNapoli, State Comptroller, State of New York, Office of the State Comptroller, to the Honorable Jeb Hensarling, Chairman, Committee on Financial Services, United States House of Representatives 1 (Apr. 26, 2017) ("It has been my experience over the past ten years as Comptroller that shareholder resolutions are an effective means to voice concerns and propose changes in order to protect Fund investments and encourage sustainable, robust corporate practices at our portfolio companies."), <http://www.osc.state.ny.us/press/release/apr17/choice-act-letter.pdf>; Statement of New York City Comptroller Scott M. Stringer on the April 19<sup>th</sup> Discussion Draft of the Financial CHOICE Act of 2017 (Act) 3 (Apr. 25, 2017) (describing some of the many achievements "made possible because of the NYC Pension Funds' long-standing right and ability to file shareholder proposals—a right and ability that would be pointlessly eviscerated by the passage of the Act"), <https://comptroller.nyc.gov/newsroom/testimony/Statement-of-New-York-City-Comptroller-Scott-M-Stringer-on-the-April-19th-Discussion-Draft-of-the-Financial-Choice-Act-of-2017-Act/>.

<sup>34</sup> See Ceres et al. at 11-12 (providing an analysis of the potential range of company costs).

<sup>35</sup> According to the ISS Voting Analytics database of Russell 3000 companies on file with CII, shareholders submitted an average of 836 proposals at 386 companies per year between 2004 and 2017. The number of submitted proposals fluctuated between approximately 800-900 proposals per year, except for a dip to 603 proposals in 2011 and 673 proposals in 2012 after the SEC's adoption of say-on-pay vote requirements.

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The average Russell 3000 company can expect to receive a proposal every 7.7 years.<sup>36</sup> In addition, proposals are typically filed with larger companies (i.e., S&P 500) that have the resources to address such shareholder input.<sup>37</sup>

For companies that receive a proposal, the median number of proposals is one per year.<sup>38</sup> When proposals are filed, companies often agree to act on the request made in the proposal. In this respect, an average of 37.5% of shareholder proposals broadly related to climate change during the 2012-2016 proxy seasons were withdrawn by filers in response to the company agreeing to the request in some way.<sup>39</sup>

The withdrawal rates for several other topics are much higher. This appears to suggest that many companies find benefits from committing to act on shareholder proposals prior to a vote.

Additionally, there is a mechanism in place that allows companies to challenge shareholder proposals. In particular, the SEC oversees a robust “no-action letter” process that allows companies to exclude proposals from the proxy ballot that do not meet certain procedural and/or substantive hurdles. This provides companies a means by which to know whether the SEC staff would recommend no enforcement action if a company excludes the proposal from the proxy. Companies have been actively utilizing this system. In fact, during the 2013-2015 proxy seasons, companies challenged nearly one-third of the shareholder proposals that were submitted and approximately half of those challenged proposals were omitted from the proxy with SEC approval.<sup>40</sup>

Importantly, the SEC has issued guidance that allows companies to exclude from the proxy any resolutions pertaining to a company’s ordinary business, stating appropriately that resolutions need to pertain to “significant policy issues” faced by companies.<sup>41</sup> We believe this approach strikes the needed balance between respecting the board’s role on corporate governance and management’s discretion to make routine business decisions, while at the same time recognizing the existence of policy issues significant enough to necessitate a shareholder vote.

H.R. 5756<sup>42</sup>

H.R. 5756 would increase the regulatory hurdles for shareholder proposals.<sup>43</sup> Current rules permit a shareholder to re-file a proposal only if it has received at least 3% of the vote on its first submission, 6% on the second and 10% on the third.<sup>44</sup>

<sup>36</sup> ISS Voting Analytics database (on file with CII).

<sup>37</sup> See Ceres et al. at 12 (discussion of frequency of shareholder proposals at public companies).

<sup>38</sup> *Id.*

<sup>39</sup> Data compiled by Ceres (on file with CII).

<sup>40</sup> See Ceres et al. at 12.

<sup>41</sup> See, e.g., Division of Corporation Finance, Securities and Exchange Commission, Shareholder Proposals, Staff Legal Bulletin No. 14E at 2 (Oct. 27, 2009), <https://www.sec.gov/interp/legal/cfslb14e.htm>.

<sup>42</sup> H.R. 5756, 115<sup>th</sup> Cong. (Mar. 14, 2018), [https://financialservices.house.gov/uploadedfiles/bills-115-duffy\\_097.pdf](https://financialservices.house.gov/uploadedfiles/bills-115-duffy_097.pdf).

<sup>43</sup> *Id.*

<sup>44</sup> 17 C.F.R. § 240.14a-8(i)(12) (Sept. 16, 2010), available at <https://www.law.cornell.edu/cfr/text/17/240.14a-8>.

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H.R. 5756 would raise those thresholds to 6%, 15% and 30%, respectively.<sup>45</sup> Those higher hurdles could knock out many important governance proposals that, if adopted, could enhance long-term shareholder value.

Experience indicates that it often takes several years for a proposal regarding an emerging issue to gain enough traction with investors to achieve double-digit votes. In many cases, these proposals eventually receive substantial support, leading to widespread adoption by companies.

The current thresholds provide a reasonable amount of time for emerging issues to gain support among investors while ensuring that only those proposals that garner meaningful support remain on the ballot for multiple years. Resubmission of proposals receiving less than 20% support for a third or fourth time is very rare. According to Institutional Shareholder Services data, since 2010, shareholders resubmitted environmental and social issue proposals in only 35 instances after receiving votes under 20% for two or more years. This affected only 26 companies.

Restricting the shareholder proposal process is likely to reduce corporate accountability to shareholders, and could create greater conflict between shareowners and public companies. For example, restricting shareholder proposals is likely to lead to shareowners more often availing themselves of the blunt instrument of votes against directors, and increased reliance on hedge fund activists to push for needed corporate changes.<sup>46</sup>

Taken together with SEC rules that preclude proposals relating to ordinary business and the SEC no-action system that prevents abuses by special interests, we believe the SEC's existing rules and thresholds related to shareholder proposals have and continue to benefit both investors and publicly traded companies.

### 3. *Quarterly Reporting*

As indicated, CII believes that investors and other stakeholders benefit when regulations "ensure that important information is promptly and transparently provided to the marketplace."<sup>47</sup> We agree with the SEC's Investor Advisory Committee that "the current degree, quality and frequency of disclosure for U.S. issuers overall is appropriate and a source of strength for the

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<sup>45</sup> H.R. 5756 § 1.

<sup>46</sup> See, e.g., "ONPOINT/A Legal Update from Dechert's Corporate Governance Practice, Shareholder Proposal Reform under the Financial CHOICE Act of 2017: A Welcome Development for Companies or a Trojan Horse?" (May 2017) ("If that outlet for complaints is removed, aggrieved shareholders may have no choice but to resort to more direct, blunt action, such as binding bylaw proposals, withhold vote for director campaigns, or even the ouster of company directors via proxy access or in a conventional contest."), [https://info.dechert.com/10.8636/nav-2017/shareholder-proposal-reform-under-the-financial-choice-act-of-2017-a-welcome-development-for-companies-or-a-trojan-horse-\(1\).aspx?sid=451ff908-fb8-4889-9fb-0a5fb8b5eda5](https://info.dechert.com/10.8636/nav-2017/shareholder-proposal-reform-under-the-financial-choice-act-of-2017-a-welcome-development-for-companies-or-a-trojan-horse-(1).aspx?sid=451ff908-fb8-4889-9fb-0a5fb8b5eda5).

<sup>47</sup> CII, Policies on Other Issues, Value of Corporate Governance, [https://www.cii.org/policies\\_other\\_issues#value\\_corp\\_gov](https://www.cii.org/policies_other_issues#value_corp_gov).

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U.S. capital markets.”<sup>48</sup> We also generally support the SEC’s outstanding proposal to delete redundant or overlapping disclosure requirements.<sup>49</sup>

*Discussion Draft Streamlining Disclosure Options to Reduce Redundant Disclosures to Investors Act (Discussion Draft)<sup>50</sup>*

The Discussion Draft would amend the federal securities laws to provide that publicly listed companies have the option to file Form 10-Q or file a quarterly press release that includes earnings results.<sup>51</sup>

We note, at the outset, the scope of the provisions of the Discussion Draft would apply more broadly than it appears the corporate special interests could agree upon.<sup>52</sup> In the recently issued white paper entitled “Expanding the On-Ramp, Recommendations to Help More Companies Go and Stay Public,” eight corporate organizations (five of which have representatives testifying at the hearing) recommended that the option to issue a press release with earnings results in lieu of a 10-Q should be applicable *only to emerging growth companies*.<sup>53</sup>

In addition, we note that the provisions of the Discussion Draft would not simply “Reduce Redundant Disclosures to Investors,”<sup>54</sup> but would appear to eliminate the timely reporting of a significant volume of potentially critical information to investors.

For example, the provisions of the Discussion Draft would appear to eliminate quarterly required information about the:

- Income statement for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding periods of the preceding fiscal year;<sup>55</sup>

<sup>48</sup> Letter from SEC Investor Advisory Committee, to Division of Corporation Finance 1 (June 15, 2016) (emphasis added), <https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac-approved-letter-reg-sk-comment-letter-062016.pdf>.

<sup>49</sup> Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors, to Brent J. Fields, Secretary, Securities and Exchange Commission 3 (Sept. 22, 2016) (“We generally support the Commission’s proposals . . . that would delete or integrate certain identified topics that are “overlapping””).

<sup>50</sup> H.R. \_\_\_, 115<sup>th</sup> Cong. (Discussion Draft May 11, 2018) [hereinafter Discussion Draft], <https://financialservices.house.gov/uploadedfiles/bills/115-rhacia.pdf>.

<sup>51</sup> *Id.* § 2(a).

<sup>52</sup> Center for Capital Markets Competitiveness et al., “Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public,” 20 (Spring 2018), <https://www.sifma.org/resources/submissions/expanding-the-on-ramp-recommendations-to-help-more-companies-go-and-stay-public/>.

<sup>53</sup> *Id.* (recommending “[g]ranting EGC’s the option of issuing a press release that includes earnings results every quarter - as opposed to a full 10-Q”).

<sup>54</sup> Discussion Draft § 2.

<sup>55</sup> 17 C.F.R. § 210.10-101(c)(2) (Aug. 12, 2011), *available at* <https://www.law.cornell.edu/cfr/text/17/210.10-01>; see EY, SEC Financial Reporting Series, 2018 SEC Quarterly Reports – Form 10-Q at 14 (2017), [http://www.ey.com/Publication/vwLUAssets/SECQuarterlyFinancialReporting10Q\\_06547\\_171US\\_21November2017.pdf](http://www.ey.com/Publication/vwLUAssets/SECQuarterlyFinancialReporting10Q_06547_171US_21November2017.pdf) (registration required).

- Statements of cash flows for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding period of the preceding fiscal year;<sup>56</sup>
- Changes to quantitative and qualitative information about market risks;<sup>57</sup>
- Material developments relating to legal proceedings;<sup>58</sup>
- Material changes in risk factors;<sup>59</sup>
- Sales during the quarter of unregistered securities and use of proceeds that have not been previously reported;<sup>60</sup> and
- Conclusions of the registrant regarding the effectiveness of the registrant's disclosure controls and procedures as of the end of the period and any change in internal control over financial reporting that occurred during the quarter.<sup>61</sup>

In addition, the provisions of the Discussion Draft would appear to potentially reduce the quality of the quarterly financial information reported and weaken the discipline and accountability of the company's reporting practices as a result of two consequences of filing the proposed press release in lieu of a Form 10-Q.

First, the provisions would appear to eliminate the required independent auditor's review and report on the company's quarterly financial information.<sup>62</sup> The review provides the accountant with a basis for communicating whether he or she is aware of any material modifications that should be made to the quarterly financial information for it to conform to with generally accepted accounting principles.<sup>63</sup>

Second, the provisions would appear to reduce the potential civil liability of the company's management for false or misleading statements contained in the quarterly reports. More

<sup>56</sup> 17 C.F.R. § 210.10-101(c)(3); *see* EY, SEC Financial Reporting Series, 2018 SEC Quarterly Reports – Form 10-Q at 14-15.

<sup>57</sup> 17 C.F.R. § 229.305 (Aug. 12, 2011), available at <https://www.law.cornell.edu/cfr/text/17/229.305>; *see* EY, SEC Financial Reporting Series at 33-34.

<sup>58</sup> 17 C.F.R. § 229.103, available at <https://www.law.cornell.edu/cfr/text/17/229.103>; *see* EY, SEC Financial Reporting Series at 76-77; *see generally* Letter from Jeffrey P. Mahoney, General Counsel, to Brent J. Fields, Secretary, Securities and Exchange Commission 6 (Sept. 22, 2016) (commenting on the need to improve rather than eliminate disclosures relating to legal proceedings).

<sup>59</sup> 17 C.F.R. § 229.503(c) (Aug. 12, 2011), available at <https://www.law.cornell.edu/cfr/text/17/229.503>; *see* EY, SEC Financial Reporting Series at 77; *see generally* Letter from Jeffrey P. Mahoney, General Counsel, to Brent J. Fields, Secretary, Securities and Exchange Commission 2-3 (Dec. 20, 2017) (commenting on the Securities and Exchange Commission outstanding proposal to amend the risk factor disclosure), [https://www.eji.org/files/issues\\_and\\_advocacy/correspondence/2017/December%202017%20SEC%20FAST%20Act%20letter%20\(final\)%20.pdf](https://www.eji.org/files/issues_and_advocacy/correspondence/2017/December%202017%20SEC%20FAST%20Act%20letter%20(final)%20.pdf).

<sup>60</sup> 17 C.F.R. § 229.701 (Jan. 4, 2008), available at <https://www.law.cornell.edu/cfr/text/17/229.701>; *see* EY, SEC Financial Reporting Series at 77.

<sup>61</sup> 17 C.F.R. § 229.307 (June 18, 2003), available at <https://www.law.cornell.edu/cfr/text/17/229.307>; 17 C.F.R. § 229.308(b) (Apr. 12, 2017), available at <https://www.law.cornell.edu/cfr/text/17/229.308>; *see* EY, SEC Financial Reporting Series at 34-36.

<sup>62</sup> 17 C.F.R. § 210.8-03 (Apr. 23, 2009), available at <https://www.law.cornell.edu/cfr/text/17/210.8-03>; 17 C.F.R. § 210.10-01(d) (Aug. 12, 2011), available at <https://www.law.cornell.edu/cfr/text/17/210.10-01>; *see* EY, SEC Financial Reporting Series at 59.

<sup>63</sup> *See* EY, SEC Financial Reporting Series at 60.

May 22, 2018  
Page 11 of 11

specifically, the Discussion Draft's proposed press release, unlike a Form 10-Q, would likely be considered "furnished" versus "filed" with the SEC.<sup>64</sup> As a result, the proposed press release would not be subject to liability under Section 18 of the Exchange Act.<sup>65</sup> The proposed press release would, however, appear to continue to be subject to the anti-fraud provisions of "Exchange Act Rule 10b-5."<sup>66</sup>

Finally, the Discussion Draft provisions would appear to potentially reduce the value and usefulness of the quarterly financial statements contained in the proposed press release because the information would presumably not be subject to XBRL data tagging generally required "for all primary financial statements, notes, and financial statement schedules filed with the SEC."<sup>67</sup>

For all these reasons, CII believes that the long-standing requirement to file a Form 10-Q with the SEC provides investors with more timely, higher quality and more useful disclosures, and instills more discipline and accountability in reporting practices than would likely be achieved by that the proposed press release contemplated by the Discussion Draft.

We commend you for holding this hearing and for your efforts to help fuel capital and growth on Main Street. We stand ready to work with you and other interested parties in support of those efforts. Thank you for considering our views. We would be very happy to discuss our perspective on these and other issues with you or your staff at your convenience. I am available at [jeff@cii.org](mailto:jeff@cii.org) or by telephone at (202) 822-0800.

Sincerely,



Jeffrey P. Mahoney  
General Counsel

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<sup>64</sup> Cf. *id.* at 53 (Explaining that a quarterly earnings release exhibit to a Form 8-K is considered "furnished" versus filed with the Securities and Exchange Commission).

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> *Id.* at 8.



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 Chicago      Facsimile: +1 312 696-6001  
 Illinois 60602

May 2018

The Honorable Jeb Hensarling  
 Chairman, House Financial Services Committee  
 2228 Rayburn House Office Building  
 Washington, DC 20515

The Honorable Maxine Waters  
 Ranking Member, House Financial Services Committee  
 2221 Rayburn House Office Building  
 Washington, DC 20515

Dear Chairman Hensarling, Ranking Member Waters, and Members of the House Financial Services Committee:

I am writing to express concern about HR 5054, the Small Company Disclosure Simplification Act, which would greatly reduce the availability of machine-readable XBRL data—data Morningstar aggregates and uses to help investors find companies in which they might want to invest. Transparency and equal access to information for large and small companies alike have been the foundation of U.S. financial markets since 1933. Excluding smaller companies, frequently startups, from this reporting would harm the ability of smaller investors to compete with large institutions when investing and providing capital to American entrepreneurs.

Requiring machine-readable disclosures lowers the barriers for deriving insights from financial filings. They also make it much easier for investment analysts to understand, initiate coverage, and spotlight relatively small and unknown companies in the market. Previously, aggregating financial filing data required the laborious transcription of filed documents, raising the possibility of the introduction of human error, not to mention a lag between submission and transcription.

Moves in the United States and around the globe toward these structured data filings have profoundly increased the transparency of capital markets. Investors now have significantly easier access to actionable insights derived from company filings, and this data is increasingly becoming available to investors more quickly. These trends toward greater transparency, in turn, improve the efficiency of capital markets.

We are pleased to see the SEC continue to make strides toward more structured data, but we are worried about policy shifts that would move us backward—impeding investors and even smaller entities hoping to attract investments.

Sincerely,

Aron Szapiro  
Director of Policy Research  
Morningstar, Inc.

CC

Rep. Edward R. Royce	Rep. Carolyn B. Maloney
Rep. Frank D. Lucas	Rep. Nydia M. Velázquez
Rep. Patrick T. McHenry	Rep. Brad Sherman
Rep. Stevan Pearce	Rep. Gregory W. Meeks
Rep. Bill Posey	Rep. Michael E. Capuano
Rep. Blaine Luetkemeyer	Rep. Wm. Lacy Clay
Rep. Bill Huizenga	Rep. Stephen F. Lynch
Rep. Sean P. Duffy	Rep. David Scott
Rep. Steve Stivers	Rep. Al Green
Rep. Randy Hultgren	Rep. Emanuel Cleaver
Rep. Dennis A. Ross	Rep. Gwen Moore
Rep. Robert Pittenger	Rep. Keith Ellison
Rep. Ann Wagner	Rep. Ed Perlmutter
Rep. Andy Barr	Rep. James A. Himes
Rep. Keith J. Rothfus	Rep. Bill Foster
Rep. Luke Messer	Rep. Daniel T. Kildee
Rep. Scott Tipton	Rep. John K. Delaney
Rep. Roger Williams	Rep. Kyrsten Sinema
Rep. Bruce Poliquin	Rep. Joyce Beatty
Rep. Mia Love	Rep. Denny Heck
Rep. French Hill	Rep. Juan Vargas
Rep. Tom Emmer	Rep. Josh Gottheimer
Rep. Lee M. Zeldin	Rep. Vicente Gonzalez
Rep. Dave A. Trott	Rep. Charlie Crist
Rep. Barry Loudermilk	Rep. Ruben J. Kihuen
Rep. Alexander X. Mooney	
Rep. Thomas MacArthur	
Rep. Warren Davidson	
Rep. Ted Budd	
Rep. David Kustoff	
Rep. Claudia Tenney	
Rep. Trey Hollingsworth	



May 22, 2018

The Honorable Jeb Hensarling, Chairman  
 Committee on Financial Services  
 U.S. House of Representatives  
 Washington, D.C. 20515

The Honorable Maxine Waters, Ranking Member  
 Committee on Financial Services  
 U.S. House of Representatives  
 Washington, D.C. 20515

The Honorable Bill Huizenga, Chairman  
 Subcommittee on Capital Markets and Government Sponsored Enterprises  
 Committee on Financial Services  
 U.S. House of Representatives  
 Washington, D.C. 20515

The Honorable Carolyn Maloney, Ranking Member  
 Subcommittee on Capital Markets and Government Sponsored Enterprises  
 Committee on Financial Services  
 U.S. House of Representatives  
 Washington, D.C. 20515

**Re: Main Street Growth Act (H.R. 5877)**

Dear Chairman Hensarling, Ranking Member Waters, Chairman Huizenga and Ranking Member Maloney,

OTC Markets Group Inc. operates the OTCQX Best and OTCQB Venture markets with over 1,200 companies meeting financial standards and providing current disclosure to investors, including many innovative and entrepreneurial 'venture' companies, trading via our SEC registered alternative trading system ("ATS").<sup>1</sup> In advance of the House Financial Services Committee's Subcommittee on Capital Markets, Securities, and Investment hearing on Legislative Proposals to Help Fuel Capital and Growth on Main Street, we want to share our concerns about the Main Street Growth Act (H.R. 5877) and the approach it takes towards regulating the U.S. venture markets.

We thank the Committee, Committee staff and Congressman Emmer for eliciting our feedback and communicating with us as they worked on the Main Street Growth Act. While we are disappointed with the bill as currently drafted, we appreciate the opportunity to be heard and look forward to working with the Committee on the important issues of small company trading and capital raising going forward.

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<sup>1</sup> The U.S. based companies on these markets have an aggregate market capitalization of over \$17 billion and employ over 45,000 people.

The Main Street Growth Act would allow the creation of “Venture Exchanges” that are intended to have trading and listing rules tailored for smaller companies and regulatory privileges that are unavailable to non-exchange markets. The bill focuses solely on national securities exchanges and excludes ATSs like ours and other innovative market models. We oppose the bill’s mandate of a single business model for the trading of all venture securities. Prescribing an exchange-only solution for venture-stage companies stifles the type of innovative, tailored market structure that has seen more than 300 companies graduate from our markets to the NYSE or Nasdaq exchanges over the past 5 years. Many small companies on our OTCQX market do not seek to graduate, and have established thriving secondary markets on our ATS platform without the cost and complexity of listing on an exchange.<sup>2</sup>

**OTC Markets Group and the ATS Model**

Successes on our markets are attributable in part to the structure of our ATS as a dealer market, allowing competing broker-dealers to directly interact with one another, as opposed to an auction (exchange model) market where broker-dealers interact only with the exchange as the centralized trading facility. Dealer markets have been shown to work better for smaller company trading, and ***all market participants should be permitted to choose the type of trading venue that best suits their needs.*** ***Companies should be free to choose their listing or designation based on value and cost, broker-dealers should be free to seek best execution from the market or broker-dealer of their choice, and investors should benefit from competition between multiple market options for buying and selling company stock.***

In an attempt to consolidate liquidity, H.R. 5877 would not permit Venture Exchanges to offer Unlisted Trading Privileges (UTP) to the securities traded there. Unlisted Trading Privileges allow securities to trade across multiple venues and were adopted, in large part, to facilitate competition between markets and deter monopolistic practices by the exchanges. Removing these privileges incentivizes anti-competitive behavior and far outweighs the potential benefits of consolidated liquidity. Forcing these participants to use a venue type prescribed by regulators is not in the best interest of any market, particularly one intended to support smaller companies and their investors.

For example, our markets cost significantly less than exchange listings, and offer streamlined compliance processes while requiring that companies meet high financial standards and produce audited financial statements among other ongoing, current public disclosure.<sup>3</sup> We work closely with state regulators, and thus far 30 states have recognized our OTCQX market as exempt from state “Blue Sky” restrictions on

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<sup>2</sup> Nine OTCQX companies submitted letters to the Committee expressing their concern over the Main Street Growth Act.

<sup>3</sup> All OTCQX and OTCQB company disclosure is made publicly available for free on the OTC Markets Group website at [www.otcmarkets.com](http://www.otcmarkets.com). The website also features transparent real-time pricing information for these companies, including the inside bid and offer as well as the full depth-of-book market data for each OTCQX and OTCQB security.

secondary trading. That allows broker-dealers to reach a wide audience of potential investors, which improves liquidity and capital raising opportunities.

#### Liquidity and Competition

High-speed exchange matching engines can capture the substantial existing liquidity in the largest public companies, but they cannot create liquidity for smaller companies. Only market makers using dealer-based markets like our ATS can provide additional liquidity as a service, which is an important reason why OTCQX and OTCQB have been successful for smaller company securities without large amounts of natural liquidity. Academic research also indicates that the competing broker-dealer model used by OTC Markets Group compares favorably to other successful smaller company trading markets.<sup>4</sup>

Market makers today can compete with the exchange markets for online broker orders based on quality of executions, costs and providing greater liquidity than is displayed on the exchanges. This structure requires a competitive, low-cost trading ecosystem that ATSs like ours can provide while exchanges cannot. We should seek to foster forward-thinking markets structure models, rather than restricting trading to a single, exchange license only model.

#### Conclusion

For the reasons outlined above, OTC Markets Group does not support the Main Street Growth Act in its current form. Our OTCQX and OTCQB markets provide secondary trading platforms for the companies that drive the Main Street economy. We have a history of providing a long-term home for these companies and their investors, and acting as a launching pad for the 60+ companies a year that grow with us and ultimately graduate from our markets to a national securities exchange listing.

We remain hopeful that Congress, the SEC and market participants can work together to provide smaller, venture companies with all of the tools necessary to foster their growth and development. Please let me know if we can provide any additional information or insight in furtherance of that shared goal.

Sincerely,



Daniel Zinn  
General Counsel  
OTC Markets Group Inc.

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<sup>4</sup> The study, attached as Exhibit A, is titled: *The rise and fall of the Amex Emerging Company Marketplace*, Journal of Financial Economics 52 (1999), 257-289.

## EXHIBIT A



ELSEVIER

Journal of Financial Economics 52 (1999) 257-289



## The rise and fall of the Amex Emerging Company Marketplace<sup>☆</sup>

Reena Aggarwal<sup>a,b,\*</sup>, James J. Angel<sup>b</sup>

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Received 12 September 1995; received in revised form 27 April 1998; accepted 1 January 1999

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### Abstract

In 1992, the Amex launched the Emerging Company Marketplace (ECM) to trade the stocks of small but growing companies. Bid-ask spreads decreased dramatically for listing firms, and news coverage increased. Executives of listing firms were quite satisfied. Yet few firms chose to list on the ECM, and it closed in 1995. What went wrong? Most Amex stakeholders had little to gain from the success of the ECM, and a series of scandals damaged the reputation of the exchange. Similar small-firm markets have also failed, largely because successful firms quickly depart for traditional markets, leaving only unsuccessful firms behind. © 1999 Elsevier Science S.A. All rights reserved.

*JEL classification:* G10; G15

*Keywords:* Amex; Nasdaq; Listings; Stock market failure; Market structure

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☆We wish to thank the Amex, the NASD, and the Vancouver Stock Exchange for providing data used in this study, along with the many senior officials of ECM-listed companies and Amex members who generously shared their insights with us. We also wish to thank the referee for very helpful comments. We also thank seminar participants at the SEC, Georgetown University, and Financial Management Annual Meetings for comments. Excellent research assistance was provided by Amin Haque. We acknowledge funding support from Georgetown University School of Business and the Georgetown University Center for Business-Government Relations. The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or commissioner. This article expresses the author's views and does not necessarily reflect those of the Commission, the commissioners, or other members of the staff.

## 1. Introduction

On March 18, 1992, the American Stock Exchange (Amex) launched the Emerging Company Marketplace (ECM) with great fanfare. The ECM was designed to trade the stocks of small but growing firms until they grew large enough to qualify for a regular Amex listing. Bid-ask spreads fell substantially for the firms that listed on the ECM, and media coverage of the ECM firms increased. However, relatively few companies followed the initial 22 firms, and the Amex closed the market on May 11, 1995.

What went wrong? How could a market produce a substantial reduction in transaction costs, yet fail to succeed? The ECM is one of many failed attempts to launch public equity markets for small stocks in the US and Europe. Why do such markets have so much trouble? This paper analyzes several factors that possibly contributed to the demise of the ECM and that shed light on the factors affecting the development of equity markets for smaller firms.

The governance structure of the Amex is one such factor. Like most traditional exchanges, the Amex is organized as a membership organization rather than a private firm. This cooperative structure means that most Amex stakeholders had little to gain if the ECM succeeded. In fact, some members of the Amex board represented firms that also owned Nasdaq market makers who were in direct competition with the Amex.

So-called 'junior' markets like the ECM also suffer from an adverse selection problem. The successful firms graduate to a listing on the senior market, leaving behind the unsuccessful ones. The junior market thus develops a reputation as a place for unsuccessful firms. As part of the Amex, the ECM had no incentive to keep firms from graduating to a regular Amex listing. This problem was made worse for the ECM because poor screening of firms led to some embarrassing scandals that hurt the ability of the ECM to attract new listings.

The market mechanism chosen for the ECM, which was the same as the regular Amex auction market, is another possible problem. Although auction markets like the Amex generally have lower bid-ask spreads than dealer markets such as Nasdaq, the wider bid-ask spreads of a dealer market can possibly motivate broker-dealers to promote a stock, increasing liquidity by widening the pool of potential shareholders. However, the ECM-listed firms enjoyed both a decrease in bid-ask spreads and an increase in their media visibility, implying that the market mechanism alone did not lead to the failure.

The experience of the ECM provides a natural opportunity to investigate these questions and to take a closer look at the competition between markets for listings. The next section presents the history of the ECM. Section 3 examines in more detail the hypotheses regarding the failure of the ECM, and presents the empirical results. Section 4 documents the failures of other markets in the US

and elsewhere that have attempted to trade very small company stocks. Section 5 concludes and summarizes.

## 2. The Amex emerging company marketplace

By 1992, the Amex was in a difficult competitive position. Traditionally, new firms first traded on the over-the-counter (OTC) market, then moved to the Amex as they grew larger, and eventually attaining a listing on the NYSE. However, the evolution of the OTC market into the Nasdaq market, with substantially improved quotation and trade dissemination compared to the old OTC market, significantly reduced the relative benefits of an Amex listing. The Amex lost significant market share in its core equity business. As a fraction of the total share volume on the traditional exchanges (NYSE, Amex, and the regionals), Amex market share fell from a peak of 29.6% in 1968 to 6.1% in 1991. The number of issuing firms fell from a level of 1215 in 1975 to 860 by the end of 1991. (These facts are derived from the 1992 fact books published by the Amex, NASD, and the NYSE.)

The Amex had tried a number of ways to increase its business in the 1970s and 1980s, including a successful entry into the options business, a failed entry into futures trading and an unsuccessful effort to trade NYSE-listed stocks. Bruchey (1991) provides more details about this and the Amex's entries into options and futures trading. The Amex also scored a series of successes by listing innovative derivative securities that the NYSE would not. Thus, it was in character with the history of the Amex that it would contemplate starting a new market in 1992.

Following the resignation of Amex Chairman Arthur Levitt, Jr. in 1989, the Amex chose former congressman James Jones as its chairman. Although he had been a public member of the Amex's board since 1987, Jones had no work experience in financial services. Jones, when first asked about the job, remarked, 'I don't really know enough about the industry (Investment Dealers' Digest, Nov. 18, 1991, p. 12)'. In addition to launching the ECM, Jones explored plans for a number of potential new ventures, including after-hours trading, a satellite trading floor in Hawaii, and a merger with the Philadelphia Stock Exchange.

The ECM was similar in concept to many of the junior or 'incubator' markets that had been started by the major stock exchanges in Europe to provide an exchange market for firms too small for the senior market. The Amex also intended to compete with Nasdaq for the listings of stocks that were too small to qualify for the regular Amex. By listing such companies early in their development, the Amex hoped to retain them as they grew bigger.

The Amex had three potential competitive advantages in this market segment. First, its auction market usually produced narrower bid-ask spreads than did

Nasdaq's dealer market. The lower transaction costs were expected to attract firms and investors. Second, at that time there was no last-trade reporting for Nasdaq stocks that were not part of the Nasdaq National Market, so investors had substantially less information about prices and volumes for such stocks. Since the Amex reported trade prices and volumes almost immediately over the consolidated tape, this improved information should also have attracted both listing companies and investors. Third, because of its traditional listing standards, the Amex had a reputation for listing firms of higher quality than many of those found in the *Pink Sheets* or the Nasdaq stocks outside the Nasdaq National Market.

The Amex adopted listing requirement for the ECM that were much less stringent than for a regular Amex listing. These are illustrated in Table 1. Not only were ECM requirements smaller in terms of stockholders' equity than were regular Amex requirements, ECM firms did not have to show positive earnings. Furthermore, there was no requirement for outside directors or audit committees. Concerns about the quality of the ECM firms were raised by the SEC and others even before the market started. Mary Schapiro, then SEC Commissioner, observed that 'Investors should understand that these companies are subject to much lower standards than companies traditionally associated with the American Exchange' (The New York Times, March 5, 1992, p. 01). The Amex sought to allay these concerns by promising to screen the companies very carefully. In addition, the Amex priced the listing fees for the ECM just slightly lower than Nasdaq's listing fees, as seen in Table 2.

### 2.1. The ECM companies

The ECM began trading on March 18, 1992 with 22 companies. The original ECM companies were relatively small, having a median market capitalization of \$18 million and a median market price of \$3.00 per share. Many of them were high-tech firms. The companies were reportedly picked by a 'blue ribbon' committee of Amex members and money managers. Most of the original companies had previously traded on what is now known as the Nasdaq Small Cap market, a lower tier of Nasdaq than the Nasdaq National Market. Six of the firms had previously traded on the *Pink Sheets*, meaning that they were even smaller and there was less trading activity in them. *Pink Sheets*' quotations are not firm; rather, they are primarily indications of interest, not commitments by dealers to trade at a given price. One of the stocks (Intertel Communications) had previously traded on the Vancouver Stock Exchange, an automated exchange known primarily for trading speculative mining stocks. Table 3 provides summary statistics about the firms that listed on the ECM and where their stocks traded prior to listing on the ECM. Table 10 of Appendix A contains more details about the firms.

Table 1  
Amex, Nasdaq, and NYSE initial and continuing fees  
The Amex, NYSE, and NASD charge listing firms a fee for initial listing in addition to an annual maintenance fee. The fees are usually based on the number of shares outstanding. This table demonstrates the listing and maintenance fees for selected firm sizes when the Amex ECM was launched in 1992.

Share outstanding (millions)	Original listing fees				Annual maintenance fees			
	Nasdaq	Nasdaq national market	Amex ECM	NYSE	Nasdaq	Amex	NYSE	
1	\$6,000	\$10,000	\$5,000	\$10,000	\$51,550	\$5250	\$5500	\$15,700
5	\$10,000	\$30,000	\$50,000	\$25,000	\$84,600	\$7250	\$7500	\$15,700
10	\$10,000	\$42,500	\$50,000	\$37,500	\$102,100	\$9750	\$10,000	\$15,700
25	\$10,000	\$50,000	\$50,000	\$52,500	\$154,600	\$13,250	\$13,000	\$31,400
50	\$10,000	\$50,000	\$50,000	\$77,500	\$242,100	\$20,000	\$13,500	\$41,840
100	\$10,000	\$50,000	\$50,000	\$127,500	\$417,400	\$20,000	\$13,500	\$82,090
200	\$10,000	\$50,000	\$50,000	\$227,500	\$767,100	\$20,000	\$13,500	\$162,590
Maximum	\$10,000	\$50,000	\$50,000	\$227,500 + \$0.001* shares over 100 millions	\$1,467,100 + \$0.0009* shares over 300 millions	\$20,000	\$13,500	\$500,000

Source: Amex listing fee data published in 1993.

Table 2  
Amex, NYSE, and Nasdaq comparative listing requirements in 1992

This table contains representative initial listing standards for the Nasdaq, Amex, and NYSE at the time of the inauguration of the Amex ECM in 1992, obtained from the individual markets. All markets also have lower standards for continued inclusion on their lists. Some alternative standards exist.

Nasdaq	Nasdaq national market system	Amex ECM		Amex	NYSE
		(Companies presently not trading on Nasdaq)	(Companies presently trading on Nasdaq)		
Total assets	\$4 million	—	\$4 million	\$2 million	—
Stockholder's equity	\$2 million	—	\$2 million	\$1 million	\$4 million
Net tangible assets	—	\$4 million	—	—	—
Net income	—	\$400,000 <sup>a</sup>	—	—	\$18 million
Pretax income	—	\$750,000 <sup>a</sup>	—	—	—
Public float (shares)	100,000	500,000	250,000	\$750,000 <sup>a</sup>	\$2.5 million <sup>c</sup>
Market value of public float	\$1 million	\$3 million	—	500,000	1,100,000
Market value	—	—	\$2.5 million	—	—
Market makers	2	2	—	\$1	\$18 million
Minimum price	\$3	\$5	\$1	\$3	—
Public Shareholders	300	400-800 <sup>b</sup>	300	300	2000 <sup>d</sup>

<sup>a</sup>In last fiscal year or two of last three fiscal years.

<sup>b</sup>Based on number of shares publicly held and average daily trading volume.

<sup>c</sup>In addition, the firm is required to have \$2.0 million in pretax income for each of the preceding two years or a total of \$6.5 million for the sum of the last three years with \$4.5 million in the preceding fiscal year. All three years must be profitable. The alternative is an aggregate of \$6.5 million in pretax income for the last three years and a minimum of \$4.5 million in the preceding year, with all three years profitable.

<sup>d</sup>Round lot holders. Alternatively, a firm can have 2200 total shareholders together with average monthly trading volume of 100,000 shares.

Table 3  
Summary statistics on ECM firms

Panel A contains summary statistics for the 65 firms that listed on the Amex ECM between March 18, 1992 and May 11, 1995. The number of market makers in each stock before listing was obtained from the NASD, Amex, or the *Pink Sheets*. Panel B contains information on the source of listings for the ECM. The original firms are the firms that listed on the ECM when it commenced operations on March 18, 1992, and the additional firms are those firms that listed later.

Panel A: Summary statistics on the listed firms

	Market capitalization (millions)	Stock price	Number of pre-ECM market makers
Mean	\$28.8	\$4.34	9.61
Median	\$15.1	\$3.38	8.00
Standard deviation	\$38.8	\$3.17	6.57
Minimum	\$3.0	\$0.69	1
Maximum	\$253.7	\$15.19	30
Numbers of firms	65	65	46

Panel B: Sources of ECM listings

Prior market	Original firms	Additional firms	Total firms
Nasdaq - not national market	15 (68.2%)	11 (25.6%)	26 (40.0%)
<i>Pink sheets</i> /Nasdaq Bulletin Board	6 (27.3%)	15 (34.9%)	21 (32.3%)
No previous market	0 (0.0%)	5 (11.6%)	5 (7.7%)
Vancouver stock exchange	1 (4.5%)	3 (7.0%)	4 (6.2%)
Initial public offering	0 (0.0%)	3 (7.0%)	3 (4.6%)
Spinoff	0 (0.0%)	3 (7.0%)	3 (4.6%)
London stock exchange	0 (0.0%)	1 (2.3%)	1 (1.5%)
Pacific stock exchange	0 (0.0%)	1 (2.3%)	1 (1.5%)
Toronto stock exchange	0 (0.0%)	1 (2.3%)	1 (1.5%)
Total	22 (100%)	43 (100%)	65 (100%)

As time progressed, the ECM listed smaller firms and firms that had been delisted from Nasdaq. Few of the additional listings came from the Nasdaq Small Cap market. Most came from the *Pink Sheets* or elsewhere. Five of the firms were private firms that had no public market for their stocks, not even in the *Pink Sheets*.

The Amex used the same market mechanism for the ECM stocks as for the regular Amex stocks. Eleven different specialist firms handled the trading in the original ECM stocks along with their regular stocks at various posts on the Amex trading floor. Although in general the ECM stocks traded like regular

Amex stocks, there were a few differences. The ticker symbols for ECM stocks carried the suffix 'EC', which made it difficult for some brokers to access information about the firms on their computer systems. Furthermore, ECM-listed stocks were not automatically marginable like regular Amex-listed stocks.

Another difference between the regular Amex and the ECM was that, unlike regular Amex-listed firms, ECM firms were not automatically exempt from the SEC's penny stock disclosure rules. SEC Rules 15g1–15g6, which generally require that brokers selling unlisted stocks with a price less than \$5.00 per share must provide additional written disclosures to customers about the risks of such stocks. This meant that brokerage firms would incur additional compliance costs and paperwork in determining which ECM firms were covered by the penny stock disclosure rules, making it less likely that the firms would want to bother promoting ECM-listed firms. Seguin and Smoller (1997) address the trading and risks involved in penny stocks.

## 2.2. Scandals and embarrassments

Almost immediately after the ECM started, questions arose about the care with which the Amex had screened the ECM firms. *Business Week* (April 13, 1992, p. 78) and *The Wall Street Journal* (July 2, 1992, p. A1) reported that the controlling shareholder of one ECM-listed firm, PNF, a maker of flame retardants, had previously been barred for life by the Amex and was a convicted arsonist. Other scandals also beset the market. In May 1993, the SEC temporarily suspended trading in Digitran, the first ECM firm to graduate to the regular Amex, in May 1993 pending an investigation of the firm's accounting methods. Later, *Business Week* (Sept. 12, 1994, p. 80) reported that the CEO of Printron had been sued twice by the SEC for securities violations – once as a man and once as a woman – and had not revealed this information to the Amex.

Perhaps even more embarrassing than the scandals, two of the original ECM firms, North Coast Energy and Ocean Optique, voluntarily returned to trading on Nasdaq. Ken Gordon, the CFO of Ocean Optique, stated, 'We were almost illiquid on the Amex, and would sometimes go an entire week without trading' (Securities Week, Nov. 23, 1992, p. 4).

This U.S. General Accounting Office delivered more bad news in 1994, finding 'weaknesses in Amex's practices of assessing companies' qualifications for Marketplace listings' (Report # GAO/GGD 94-72). Specifically, the Amex had not screened the early firms thoroughly, although it later improved its screening process. The report also found that the Amex's reliance on qualitative listing factors, such as the companies' prospects, was potentially misleading to investors who were expecting tougher listing standards.

### 2.3. Closure

Throughout the life of the ECM, new listings replaced some of the firms that left, so the total number of ECM listings stayed relatively stable. Nonetheless, by the end of 1992, there were only 28 companies on the ECM, far below the 50 that Amex officials had envisioned. The number fell to 22 by the end of 1993. Some smaller firms joined the ECM in 1994, bringing the number of listings to 35 and the median market capitalization from its original \$18.4 million down to \$6.8 million. Several of the later listings on the ECM were 'fallen angels', companies that had been delisted from Nasdaq and then traded in the *Pink Sheets*. In August 1993, Jones, who had personally championed the ECM, resigned as chairman of the Amex to become the US ambassador to Mexico. He was replaced in 1994 by Richard Syron, who had been president of the Federal Reserve Bank of Boston. Syron stopped actively marketing the ECM pending a review, and the Amex announced the closure of the market on May 11, 1995. After the closure, the remaining ECM firms were permitted to continue trading on the ECM. Many of them moved up to the regular Amex list as soon as they met the listing standards, although as of this writing several of them are still trading as ECM stocks.

During its life, the ECM listed a total of 65 firms. Table 4 contains information about the status of the firms after the ECM closed. As of June 1997, 29 of those 65 firms had graduated to a primary Amex listing, and 15 were still on the ECM. Eight of the firms had voluntarily switched to Nasdaq, and 11 were delisted by the Amex for failing to meet listing requirements. One stock was listed in Toronto and one other on the NYSE.

Table 4  
Primary listing status of ECM-listed firms, May 1995 and June 1997

This table presents the primary listing status of the 65 firms that listed on the ECM as of the May 1995 announcement of the closure of the market and also as of June 1997. 'Delisted' refers to firms that were removed from the Amex for failure to meet Amex listing requirements or whose trading was suspended by the Amex. Nasdaq refers to firms that switched voluntarily to Nasdaq.

Primary listing of firm	Status as of May 1995 number of firms	Status as of June 1997 number of firms
Amex ECM	32 (49.2%)	15 (23.1%)
Amex (regular)	19 (29.2%)	29 (44.6%)
Delisted	7 (10.8%)	11 (16.9%)
Nasdaq	5 (7.7%)	8 (12.3%)
NYSE	1 (1.5%)	1 (1.5%)
Toronto	1 (1.5%)	1 (1.5%)
Total	65 (100%)	65 (100%)

### 3. Hypotheses regarding the failure of the ECM

#### 3.1. Governance structure of the Amex and the ECM

The governance structure of the Amex might have contributed to the failure of the ECM because important Amex constituencies had little to gain from the ECM. Like most traditional stock exchanges, the Amex is organized as a not-for-profit membership organization. As Hart and Moore (1995) eloquently point out, this cooperative organization can lead to serious inefficiencies. Whereas an investor-owned firm has the clear objective of maximizing shareholder value, the members of a cooperative have divergent interests. Members buy seats on the Amex in order to make money by executing trades for themselves or for their customers on the Amex. The members are more concerned with earnings from their trading operations than they are with maximizing the value of an Amex membership.

It is interesting to note that none of the successful entrants into the U.S. equity market in recent years have been organized as cooperatives. Electronic trading networks such as POSIT and Instinet are for-profit ventures. Furthermore, several exchanges, including Amsterdam, Australia, Milan, and Stockholm, have converted or are in the process of converting from cooperative ownership to limited liability companies.

Euroquote, an earlier attempt to start a pan-European trading system, highlights some of the problems cooperative organizations face when attempting to launch new ventures (see Clarkson, 1990; Financial Times, Mar 13, 1991, p. 34 and Sept. 24, 1991, p. 25). The Federation of European Stock Exchanges sought to make it possible for its member stock exchanges to share prices and quotations. In its first phase, Euroquote would have provided only price information, but the long-term goal was to become an integrated European trading mechanism. Euroquote would have allowed the member markets to compete with one another in a manner similar to the competition between market makers on Nasdaq. However, the system was scuttled prior to launching because several member exchanges felt their individual interests were threatened by it.

Apparently few, if any, Amex stakeholders had a stake in the ECM. As the CEO of one ECM-listed firm (who requested anonymity) bluntly put it, 'There was no constituency inside the exchange [for the ECM]'. Clearly, the Amex officials who had championed the ECM, such as its chairman, James Jones, had a reputational stake in its success. However, the other constituencies had little to gain from the ECM. Some of the existing Amex-listed companies were concerned that the new segment with its lower listing standards would damage the reputation of Amex-listed firms (Investment Dealer's Digest, Nov. 18, 1991, p. 12). Even if the ECM had succeeded, it would not have benefited the options traders, because the Amex trades options mostly on non-Amex stocks.

Although the Amex specialists would have benefited had the ECM resulted in more high-volume regular Amex listings, conversations with some Amex specialists indicate that they were not too interested in the ECM firms themselves. The low potential trading volumes of the tiny ECM firms meant that they had little immediate profit potential (Hasbrouck and Sofianos (1993) report that NYSE specialists earn substantially lower profits per trade on less frequently traded stocks). Because the specialists were already trading the regular Amex stocks, they did not give the ECM firms much attention. However, some specialists strongly supported the ECM because they viewed it as providing the listings of the future.

The retail brokerage firms that route orders to the Amex should not have been particularly concerned over whether a stock traded on the ECM, the regular Amex, or the NYSE. They would have earned the same commission regardless of where a trade executed. However, Amex member firms that also owned Nasdaq broker-dealers stood to gain from the failure of the ECM, because their affiliated market makers could earn more money from Nasdaq's traditionally wider bid-ask spreads.

The composition of the Amex's 25-member Board of Governors in 1992 reflects the diverse interests of the membership. The Amex, like the NYSE and the NASD, is required to have public board members. There were 12 board members who represented the public, including former Federal Reserve Chairman Paul Volcker and Princeton University Professor Burton Malkiel. Several of these public board members were affiliated with the larger Amex-listed firms. The remainder of the board positions were split between specialist firms, floor brokers, and brokerage firms. Six of the Amex governors represented firms that were also affiliated with Nasdaq market makers, including Merrill Lynch, Smith Barney, Prudential, and Nomura. Thus, the potential supporters of the ECM among the floor traders and specialists were in a minority on the board and unable to save the ECM when the board was deciding its fate.

One example of how this cooperative governance hurt the ECM was in the screening of ECM firms. Some of the poor quality firms that hurt the ECM's reputation were introduced by members of the exchange, and thus received less than appropriate scrutiny. Another example is the response of the Amex to the concerns of the larger listed firms, represented by 'public' members of the board, that the ECM would hurt the reputation of the larger firms. Thus, the Amex took several steps to differentiate the ECM firms from the regular Amex-listed firms, such as adding the problematic 'EC' suffix to the ticker symbol of ECM firms.

In addition, because the Amex had designed the ECM to generate more listings for the regular Amex, there was no incentive for the ECM to discourage firms from moving up to the main list. Indeed, conversations with executives of ECM-listed firms indicate that the Amex encouraged the firms to move to the

main list as soon as they qualified. An independent market like Nasdaq competes aggressively to keep its listed firms from moving to another market. This accentuated the adverse selection problem described below.

### 3.2. *Adverse selection*

The ECM, like other junior markets, suffered from an adverse selection problem. By definition, such markets target firms that are too small for the senior market. Some of the firms do well and graduate to the senior market. The firms that do not do well remain behind in the junior market. Thus, the junior market must constantly list new firms or face a drop in listings. For example, of the 28 firms on the ECM at the end of 1992, 16 (57.1%) were gone by the end of 1993.

If anything such as an economic recession, a market downturn, or a scandal disrupts the flow of new listings, the junior market will comprise only the less successful firms, damaging its reputation. The declining number of listings and an unsuccessful reputation further deters new firms from listing in the junior market, setting up a vicious circle of decline. The poor screening by the Amex made this problem even worse. The scandals created a reputation for the ECM as a collection of poorly screened firms, further deterring other firms from considering a listing.

#### 3.2.1. *Stock market performance of ECM firms*

The adverse selection hypothesis implies that successful firms would quickly move on to the regular Amex and that the less successful firms would spend more time on the ECM. This was indeed the case. To investigate this, we examine the stock market performance of the ECM firms during the time they were listed on the ECM. Overall, many of the ECM-listed stocks performed poorly, as indicated by the 11 delistings out of the 65 stocks. To examine aggregate performance of the ECM stocks, we calculate returns on a value-weighted portfolio of firms that listed on the ECM during the time period that they were on the ECM. We compare the performance of this ECM portfolio with the Nasdaq Composite Index and with a control portfolio made up of 65 size- and industry-matched firms. We use a group of control firms as a benchmark in light of Barber and Lyon's (1997) finding that control firms generally provide less biased estimates of long-term abnormal returns. (Results for a variety of different benchmarks were quite similar and are omitted for brevity.) The control firms are selected from the Center for Research in Security Prices database by matching each ECM firm with the Nasdaq-listed firm in the same two-digit SIC code that was closest in market capitalization to the ECM firm. A firm is included in the control firm portfolio only during the time its matching ECM firm is in the ECM. For comparison, we set each portfolio only during the time its matching ECM firm is in the ECM. For comparison, we set each

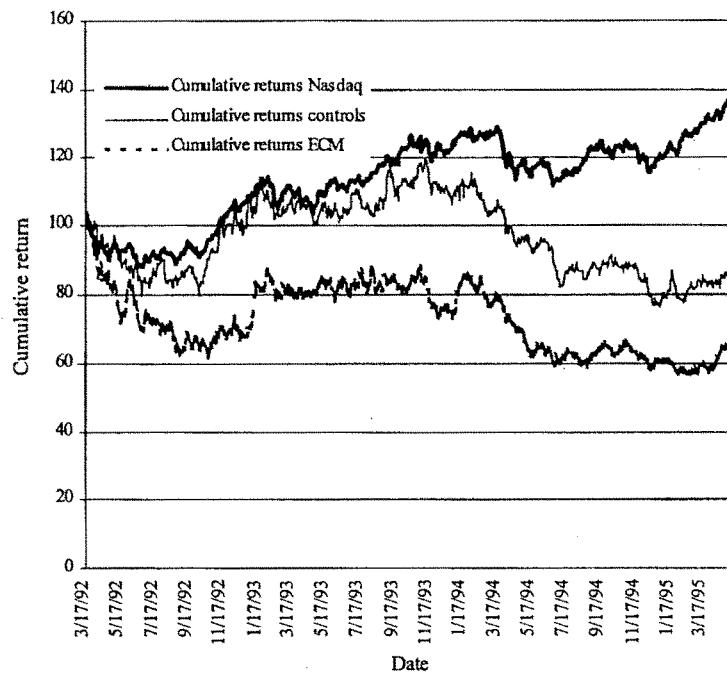


Fig. 1. This figure presents a time series of a value-weighted index of the cumulative buy-and-hold returns of the 65 stocks that were members of the Amex ECM during their tenure on the ECM compared with the cumulative buy-and-hold returns for the Nasdaq Composite Index and with a value-weighted index of 65 size- and industry-matched controls. The index values for March 17, 1992 are set to 100.

portfolio to a starting value of 100 as of the close of the first day of trading on the ECM (March 17, 1992). Fig. 1 shows that the returns on the ECM portfolio fall by about 40% during the life of the ECM, while the returns on the control portfolio fall about 20% and the Nasdaq Composite Index increases almost 40%. Of the 65 ECM firms, 39 decline in value during their tenure on the ECM, 25 increase in value, and one is unchanged.

In Table 5, we compare the cumulative buy-and-hold returns of the individual firms during the periods that they were listed on the ECM with the returns on the two different benchmark portfolios, the Nasdaq Composite Index and the control firms benchmark. In the spirit of Barber and Lyon (1997), we examine the buy-and-hold-abnormal return ( $BHAR_{it}$ ) for stock  $i$  over the period  $\tau$  for which it was listed on the ECM, which we compute as follows:

$$BHAR_{it} = \prod_{t=1}^{\tau} [1 + R_{it}] - \prod_{t=1}^{\tau} [1 + E(R_{it})] - 1, \quad (1)$$

Table 5  
Stock market performance of ECM listed firms

This table presents the stock market performance of the 65 firms that listed on the Amex ECM from the time that the firms listed on the ECM until the earlier of the time that the firms left the ECM or the ECM closed in May 1995. Performance is presented for the cumulative buy-and-hold return, and also for cumulative buy-and-hold abnormal returns relative to the size- and industry-matched control firms described in the text, as well as for market model adjusted returns using the Nasdaq Composite Index as a benchmark. The *p*-value is for the hypothesis that the probability of a negative return is greater than the null hypothesis of a 50% probability.

Number of firms	Time listed on ECM			Overall
	Less than 200 days	200-300 days	More than 300 days	
	16	23	26	
Mean	21.5%	10.0%	-23.9%	0.7%
( <i>t</i> -stat)	(1.24)	(0.52)	(-1.80)	(-0.08)
Median	12.8%	-10.6%	-38.1%	-16.8%
% negative	31.3%	60.9%	76.9%	60.0%
( <i>p</i> -value)	(0.993)	(0.149)	(0.003)	(0.053)
<i>Cumulative buy-and-hold abnormal return (Control firms benchmark)</i>				
Mean	22.5%	2.6%	-19.5%	-1.4%
( <i>t</i> -stat)	(1.15)	(0.16)	(-1.44)	(-0.15)
Median	11.0%	-14.2%	-39.5%	-19.3%
% negative	37.5%	65.2%	76.9%	63.1%
( <i>p</i> -value)	(0.934)	(0.072)	(0.003)	(0.018)
<i>Cumulative buy-and-hold abnormal return (Nasdaq Composite Index benchmark)</i>				
Mean	20.4%	6.0%	-27.0%	-3.6%
( <i>t</i> -stat)	(1.07)	(0.34)	(-2.19)	(-0.39)
Median	10.0%	-14.2%	-35.4%	-21.1%
% negative	31.3%	60.9%	80.8%	61.5%
( <i>p</i> -value)	(0.934)	(0.149)	(0.001)	(0.031)

where  $R_{it}$  is the return for stock  $i$  during period  $t$  and  $E(R_{it})$  is given by the benchmark return. The mean BHAR is not significantly different from zero for both benchmarks. However, the median firm's BHAR is significantly negative for both benchmarks; the median ECM firm suffers a decline of 19.3% compared with the control firms.

Furthermore, the adverse selection effect is apparent in Table 5, which also displays the results by length of tenure on the ECM. Firms that remain on the ECM for under 200 days perform better than the control firm portfolio, with

a mean and median BHAR of 22.5% and 11.0%, respectively. The mean returns are not significant. Only 37.5% of these firms have negative cumulative abnormal buy-and-hold-returns relative to the control firms benchmark. The firms that stay on the ECM longer than 300 days suffer a median BHAR of  $-39.5\%$ , and 76.9% of them have negative BHARs. Once again, the mean returns were generally insignificant.<sup>1</sup>

This poor stock price performance is indicative of the low quality of the ECM firms and of the adverse selection problem faced by the ECM, in which the good firms graduate as soon as they can, leaving only the weaker firms behind. The ECM itself is not responsible for the price performance of the firms; such firms would have suffered price drops on whatever market they traded.

Although many of the ECM-listed stocks perform poorly, a few do quite well. Spectrum Signal Processing, Media Logic, and Colonial Data Technologies all tripled in value while they were listed on the ECM. Yet two of these winners, Colonial Data Technologies and Spectrum Signal Processing, voluntarily switched to Nasdaq, further damaging the image of the ECM.

### 3.3. Market mechanism

The auction market mechanism of the ECM is another possible factor in its failure, because small firms in the United States have traditionally chosen to be traded in a dealer market. For example, the majority of the small firms that meet the listing requirements of the Amex and the regional exchanges have to choose a dealer market. For example, as of July 1997, 1328 firms with a market capitalization of less than \$100 million in the Compustat PC-Plus database meet the Amex listing requirements for stockholders' equity, pretax income, shares outstanding, market capitalization, and price. Of these firms, 1066 (80.3%) are listed on Nasdaq, 77 (5.8%) on the NYSE, and 185 (13.9%) are listed on the Amex. This preference for dealer markets potentially did not help attract listings to the ECM, because the Amex used the same auction market mechanism for the ECM as it did for its main stocks.

An auction market like the Amex generally produces narrower bid-ask spreads than dealer markets by consolidating trading activity in one location

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<sup>1</sup> One potential problem that could bias these tests would be a high degree of correlation (e.g., an 'ECM factor') among the ECM stocks. To check for this, we calculate the Pearson correlation coefficient among all possible pairs of ECM stock returns during the time they were listed on the ECM, as well as the correlations among all possible pairs of controls. The mean correlation among the ECM stocks is only 0.008 with a median of 0.003, compared with a mean correlation among the pairs of controls of 0.004 with a median of 0.005. The 10th and 90th percentiles for the ECM firms are  $-0.10$  and  $0.12$ , and the 10th and 90th percentiles for the controls are  $-0.10$  and  $0.11$ . We thus do not think that there is a serious correlation bias affecting the stock returns of the ECM firms.

under the oversight of a single specialist who also acts as a dealer.<sup>2</sup> The wider Nasdaq bid-ask spreads have led to much criticism of Nasdaq, including allegations of oligopolistic behavior and price fixing (Forbes, Aug. 16, 1993, pp. 74–79; Christie and Schultz, 1994).<sup>3</sup> But differences in spreads are not necessarily evidence that one type of market mechanism is inherently better than another. In addition to the bid-ask spread, there is also the issue of 'sponsorship', or the marketing efforts of some broker-dealers on behalf of the stocks they cover. Many Nasdaq market makers publish security research about the stocks in which they make markets. This increases the information available to investors. Furthermore, Nasdaq broker-dealer firms have a double incentive to promote trading activity in the stocks in which they make markets, because they earn both commission revenue and dealer trading profits on orders that they generate. Some broker-dealers pass this incentive on to their registered representatives by allowing them to keep a higher fraction of the gross commissions on such stocks (Morgenson, 1993). In contrast, Amex Rule 190 prohibits its specialists from promoting their stocks.

It is not clear a priori which type of market mechanism should provide the lowest cost of capital for a firm. Recent theoretical work by Lipson (1997) and Aggarwal and Angel (1998) supports the notion that the smallest firms would prefer a dealer market and the larger firms an auction market. A dealer market generally has higher bid-ask spreads, which would be expected to increase the cost of capital in the spirit of Amihud and Mendelson (1986). Yet the higher spreads give dealers more incentive to make a market in a given stock. Multiple dealers may devote more capital to the market-making process than a monopolist specialist, which should help make the stock more liquid.<sup>4</sup> Furthermore, the higher spreads give dealers more incentive to provide security research and inform investors about a stock. This effect increases the number of investors who 'know about' the stock in the sense of Merton (1987), which leads to a lower cost of capital. Thus, a small firm might rationally choose a higher-transaction-cost

<sup>2</sup> Numerous studies investigate differences between dealer and auction markets. See Ule (1937), Van Horne (1970), Ying et al. (1977), Sanger and McConnell (1986), McConnell and Sanger (1987), Christie and Huang (1993), Kadlec and McConnell (1994), Dharan and Ikenberry (1995), Huang and Stoll (1996), and Clyde et al. (1998) for a sample of the work on differences across exchanges.

<sup>3</sup> For more on the alleged Nasdaq collusion, see Barclay (1997), Bessembinder (1997), Demsetz (1997), Harris and Schultz (1997), LaPlante and Muscarilla (1997), and Kandel and Marx (1997).

<sup>4</sup> However, to the extent that net capital requirements have any relation to the capital employed, an exchange can require its specialists to maintain higher capital levels, although it cannot compel them to use the additional capital to take larger positions. For example, NYSE Rule 104.20 requires a specialist to be able to assume a position of 150 round lots of a given stock, and to maintain sufficient net capital equal to 25% of this position requirement. Thus, a \$30 stock adds \$112,500 to the NYSE specialist's net capital requirement. Under SEC Rule 15c3-1, each stock over \$5 adds only \$2,500 to a Nasdaq market maker's net capital requirements, up to a total requirement \$1,000,000.

market if that market provides additional marketing services for its stock. This is similar to a manufacturer who chooses a high-cost boutique as a channel of distribution because it provides marketing support that a low-cost mass merchandiser might too.

Even though some small firms might prefer a dealer market, it does not follow that this is the preference for all small firms. Whether the potential for increased investor interest provided by a dealer market is offset by its higher transaction costs is likely to differ from company to company. For some firms, the added marketing from Nasdaq broker-dealers might not be worth the higher transaction costs. Other firms might believe that the reputation effect of an Amex listing would increase the pool of potential investors more than would the marketing efforts of Nasdaq broker-dealers. Thus, it is likely that some small firms would be interested in an auction market. Indeed, choosing a different market mechanism from Nasdaq could have been a viable way to differentiate the ECM product and reach a niche of small firms that did not necessarily prefer a dealer market.

The hypothesis that the market mechanism contributed to the failure of the ECM contains several empirical implications. As discussed above, there are two dimensions of market quality that affect the decision regarding where to list. One dimension is that of transaction costs, which we measure with the bid-ask spread.<sup>5</sup> The ECM resulted in significant reductions in bid-ask spreads. The other dimension is the number of investors familiar with the firm, which we measure indirectly by looking at total trading volume and media visibility. Results on average daily trading volume are mixed, but showed a trend toward an increase in trading volume. Media visibility generally increases for the ECM-listed firms compared with a set of size- and industry-matched controls. Thus, the ECM seems to improve market quality on both dimensions, casting doubt on the hypothesis that the market mechanism alone caused the failure. The following subsections present these empirical results.

### 3.3.1. Effect of ECM listing on bid-ask spreads

We obtain data on price, volume, and bid-ask spreads from the Amex, the NASD, the Vancouver Stock Exchange, Dow Jones News Retrieval, and the *Pink Sheets* for 1992 published by the National Quotation Bureau. Bid-ask spread and volume data are not available for firms that were not publicly traded before they joined the ECM (such as initial public offerings and spinoffs). Volume data also are generally not available for firms that traded in the *Pink Sheets*. Consistent with the findings of Christie and Huang (1993) and Huang and Stoll (1996), our sample shows a significant drop in the average bid-ask

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<sup>5</sup>See Ule (1937), Van Horne (1970), Ying et al. (1977), Sanger and McConnell (1986), and McConnell and Sanger (1987) for a sample of the work on exchange listings.

Table 6  
Effect of ECM listing on bid-ask spreads

This table presents the effect of ECM listing on the quoted closing bid-ask spreads for a sample of 49 ECM firms for which bid-ask spread data are available both before and after listing. Bid-ask spreads before listing are calculated for those firms that were traded on the Nasdaq Small Cap for the month prior to listing. For stocks that traded in the *Pink Sheets*, the week prior to the ECM listing date is used. Bid-ask spreads after listing are calculated for the month following the listing date. Data are obtained from the NASD, Amex, Vancouver Stock Exchange, and the *Pink Sheets*.

	ECM firms					
	Dollar bid-ask spreads			Percentage bid-ask spreads		
	Before listing	After listing	Difference	Before listing	After listing	Difference
Median	0.375	0.160	-0.210	14.1%	4.9%	-7.9%
Mean	0.411	0.168	-0.244	15.2%	6.2%	-8.9%
Standard error of the mean	0.039	0.008	0.035	1.5%	0.8%	1.3%
Minimum	0.034	0.082	-1.068	1.9%	1.6%	-49.7%
Maximum	1.30	0.344	0.078	54.6%	32.0%	4.5%
Number of increases			5			5
Number of decreases			44			43
Number unchanged			0			0
<i>t</i> -statistic of mean difference			-6.90			-6.63
Sign test <i>p</i> -value			0.000			0.000
Wilcoxon signed rank test			0.000			0.000
<i>p</i> -value						

spread for the 49 ECM firms for which before and after bid-ask spread data are available. As seen in Table 6, the percentage bid-ask spread falls for 43 of the 49 firms, from an average of 15.2% before listing to 6.2% after listing, a decline of 59%.

Intertel Communications, which had previously traded on the Vancouver Stock Exchange, saw its spread rise from 1.9% to 3.9%. Part of this increase might be attributable to the tick size used in Vancouver, where the minimum price variation is one Canadian cent. On the Amex, the minimum tick size for a stock in this price range is 1/16, or \$0.0625. The five other firms whose spreads increase generally have a larger number of market makers prior to listing than do the other ECM firms. The mean number of market makers for this group is 18.8 with a median of 18, compared with a mean of 8.5 and a median of eight for the other ECM firms.

### 3.3.2. Effect of ECM listing on average daily trading volume

Another natural measure of liquidity, average daily trading volume, shows mixed results. Table 7 shows the results on average daily trading volume for the

Table 7  
Effect of ECM listing on average daily trading volume

This table presents information on the trading volume for the 35 firms that listed on the Amex ECM for which before and after trading volume are available. Trading volume data prior to listing are unavailable for firms that were IPOs, spinoffs, had no public market, or were traded on the *Pink Sheets*. Statistics are also presented for 35 Nasdaq control firms that were matched to the ECM firms by two-digit SIC code and market capitalization at time of listing. Data are from the Amex, Bloomberg, FactSet Research Systems, and the NASD.

	ECM firms		Industry-and size-matched controls	
	Benchmark		Benchmark	
	Prior year	Year to date	Prior year	Year to date
Average daily volume before listing date				
Median	4577	10,894	14,737	14,678
Mean	15,873	22,829	44,362	56,726
(Standard deviation)	(22,686)	(27,768)	(82,659)	(135,327)
Average daily volume after listing date				
Median	7411		11,838	
Mean	14,465		(37,704)	
(Standard deviation)	(18,030)		(73,440)	
Median percentage increase	101.64%	– 22.14%	– 9.26%	– 23.91%
Number of firms with higher volume	21	14	13	2
Number of firms with lower volume	14	21	22	33
Difference in mean before and after listing ( <i>t</i> -statistic)	– 1372 (– 0.36)	– 8364 (– 2.00)	– 6658 (– 1.26)	– 63,384 (– 2.56)
Sign test (Median percentage increase > 0)	0.1553	– 0.9123	0.9552	1.00
<i>p</i> -value				
Wilcoxon signed-rank test (Median percentage increase > 0) <i>p</i> -value	0.003	0.810	0.725	0.948

35 ECM firms for which before and after volume data are available, along with the results for their controls. We compare the average daily volume for the firms during their life on the ECM with their average daily volume in the calendar year prior to listing and the year-to-date volume prior to listing. Compared with the full calendar year prior to listing, average daily volume after listing on the ECM increases for 21 firms and decreases for 14 firms. Median average daily trading volume increases significantly from 4577 to 7411 shares per day

although the mean decreases insignificantly. The median firm's volume increases by 101.6%.

However, if we use the year-to-date period just prior to listing as the benchmark, then volume increases for only 14 firms and declines for 21 firms, and the median falls from 10,894 to 7411 shares per day. Volume for the median firm decreases by 22.1%. Table 7 shows that the average daily trading volume generally declines for the control firms for both benchmarks. Caution should be used in interpreting these trading volume numbers because the double counting of trades by Nasdaq creates an upward bias in reported Nasdaq volume compared with the Amex.<sup>6</sup>

### 3.3.3. Effect of ECM listing on media coverage

Because exchange membership can provide additional visibility for a firm, it can lead to more media coverage. This media coverage can in turn increase the pool of investors who 'know about' a firm in the sense of Merton (1987), and thus increase its liquidity. To investigate this, we examine the number of media reports, including news wires and newspaper stories, disseminated about these firms. We collect media reports on the firms for one year before and after their ECM listing date from the ALLNWS file on Lexis/Nexis to determine whether ECM listing is followed by an increase in media coverage. We exclude stories about the ECM listing itself, duplicate records, and PR wires that are issued by the firm. If ECM listing increases the visibility of the firms, then we would expect an increase in news stories. On the other hand, with less of a dealer network to promote the stock, we would expect a decrease in news stories. Because the changes in visibility could be gradual, we examine three-month, six-month, nine-month, and one year windows around the listing date. We also examine changes in news coverage for the industry and size-matched Nasdaq-traded control firms as described above.

Table 8 shows that the number of news stories increases slightly but insignificantly when comparing the three months prior to listing with the three months after. The same is true in comparing the six months before with the six months after listing. However, news coverage is significantly higher in the nine-month and one-year windows. For the 12 months before and after ECM listing, the

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<sup>6</sup> On a quote-driven market such as the Amex, a large number of transactions are directly between the buyer and the seller; such trades and their attendant volume will be reported only once. The Amex reports in its 1992 Fact Book that in 1991 its specialists participated in only 11.2% of the total transactions in the market. In a dealer market such as Nasdaq, the dealers act as intermediaries, and can buy shares from a dealer, who later sells the shares to the natural counterparty. Such a trade would be reported as two trades on Nasdaq; if the buyer had purchased directly from the natural counterparty on the Amex, only one trade would have been reported. Amex volume is, however, increased for trades in which the specialist participates. See Gould and Kleidon (1994) for an analysis of Nasdaq trading volume.

Table 8  
Media coverage before and after ECM listing

This table presents the number of news stories in the ALLNWS file on Lexis measured relative to each firm's listing date for the 65 firms that listed on the Amex ECM. News stories that were about the ECM itself and PR news wires issued by the firm itself are not included. Statistics are also presented for 65 Nasdaq control firms that were matched to the ECM firms by two-digit SIC code and market capitalization at time of listing.

	65 ECM firms						65 industry and size-matched controls					
	0–3 months			0–6 months			0–9 months			0–12 months		
	5	8	11	15	20.2	20.2	0–3 months	0–6 months	0–9 months	0–12 months	0–3 months	0–6 months
Before listing date												
Median number of stories	6	13	21	28			6	12	18	23	32	
Mean number of stories	7.3	14.3	23.3	31.8			10.8	21.5	33.0	43.2		
Median number of stories	34	41	44	51			19	29	26	28		
Mean number of stories	5	1	2	1			8	3	8	2		
Number of firms with higher number of stories	26	23	19	13			38	33	31	35		
Number of firms with same number of stories												
Number of firms with fewer stories												
Difference in mean before and after listing ( <i>t</i> -statistic)	–0.26	1.08	6.49	11.55			–0.51	–0.49	2.23	3.18		
	(–0.21)	(0.59)	(3.31)	(4.84)			(–0.46)	(–0.29)	(1.02)	(1.26)		
Sign test (Median difference > 0) <i>p</i> -value	0.1831	0.0168	0.0012	0.0000			0.9960	0.7373	0.7866	0.8432		
Wilcoxon signed rank test (Median difference > 0) <i>p</i> -value	0.087	0.047	0.000	0.000			0.984	0.906	0.426	0.375		

median number of stories about the ECM-listed firms increased from 15 to 28; 51 of the 65 firms have increases in the number of stories. In contrast, the control firms do not see significant increases in news coverage, and in fact the majority (35) of the controls actually have fewer news stories in the year after listing. Thus, listing on the ECM is associated with an increase in media coverage for the ECM-listed firms.

### 3.4. *Opinions of senior management of ECM-listed firms*

We also undertook field research to learn more about the ECM from the perspective of the ECM-listed firms themselves. We interviewed senior officials from ECM-listed firms who were personally involved with or highly knowledgeable about the original decision to list on the ECM, most of whom were CEOs or CFOs. Because of personnel turnover and the disappearance of some ECM firms, we were unable to locate such officials at all the ECM firms. Table 9 provides summary information about the interviews with 37 of the 65 firms.

In general, the officials indicate that they were satisfied with their experiences on the Amex, and most (88.6%) of them would have made the same decision if they had it to do it over again. This is strong evidence against the notion that the Amex alienated its listed companies. Indeed, many of the officials report that their firms had unsatisfactory experiences with Nasdaq before they listed on the Amex ECM.

One very important finding from the survey is that the majority (71.4%) state that they would have sought an Amex listing anyway once they qualified, even if the Amex had not started the ECM. This response indicates that the ECM was attracting few firms to the Amex that would not have eventually chosen the Amex anyway. Indeed, several of the firms joined the ECM after the Amex stopped actively marketing it because those firms wanted to be on the Amex. Thus, the ECM was redundant in that it did not attract many listings beyond the firms that would eventually have come to the Amex anyway.

During the interviews, the officials freely volunteered many insights into why they listed on the Amex and on the strengths and weaknesses of the ECM. They mentioned repeatedly that lower spreads and more visibility on the ECM were important reasons for listing. Some firms were very pleased with the various investor relations programs offered by the Amex to introduce them to potential investors. For some a contributing factor was to have a listing in the newspaper every day, because many newspapers do not carry quotes for Nasdaq Small Cap stocks. One CEO felt that an Amex listing had more visibility to Europeans than a Nasdaq Small Cap listing, and this visibility was important for raising additional financing.

Many of the officials express a strong belief in the auction market. They think that the auction market is the 'right' way to conduct a stock market. Several

Table 9  
Opinions of senior management of ECM-listed firms

This table summarizes the results of personal interviews with senior officials of 37 ECM-listed firms regarding their experiences with the ECM. We attempted to interview officials who were personally involved with, or highly knowledgeable about, the decision to list on the ECM. During the interviews, the officials were asked the questions listed here. The officials also provided additional unstructured comments and insights discussed elsewhere in the paper.

Title	Number of firms responding		
Chairman, President, EOC, COO	11 (29.7%)		
CFO	21 (56.8%)		
Investor Relations	2 (5.4%)		
Corporate Secretary or EVP	3 (8.1%)		
Total	37 (100%)		
Firm listing status as of June 1997			
Amex (regular)	19 (51.4%)		
ECM	13 (35.1%)		
Delisted	3 (8.1%)		
Nasdaq	1 (2.7%)		
NYSE	1 (2.7%)		
Total	37 (100%)		
"Were you personally involved with the listing decision?"			
Yes	No	Total	
30 (81.1%)	7 (18.9%)	37 (100%)	
"Did you think that the ECM would provide more visibility for the firm than Nasdaq?"			
Yes	No	Not sure	Total
21 (67.7%)	7 (22.6%)	3 (9.7%)	31 (100%)
"If the Amex did not have the ECM, did you think that the firm would have eventually listed anyway on the Amex?"			
Yes	No	Not sure	Total
25 (71.4%)	3 (8.6%)	7 (20.0%)	35 (100%)
"If you had it to do over again, do you think you would make the same decision?"			
Yes	No	Not sure	Total
31 (88.6%)	2 (5.7%)	2 (5.7%)	35 (100%)
"Were you satisfied with the experience of your stock on the Amex?"			
Yes	No	Not sure	Total
32 (88.9%)	3 (8.3%)	1 (2.8%)	36 (100%)

firms heard presentations from both the Nasdaq and the Amex and liked the Amex presentation better. They found that 'Amex did a better job at selling'. Other executives believe that the Amex provides better protection against short sellers because at that time there was no uptick rule on Nasdaq. This is

consistent with the notion that the Amex is attractive to firms that prefer an auction market but are too small for the NYSE.

Some firms felt that they had 'no choice' but to list on the ECM. They had been delisted from the Nasdaq National Market due to financial difficulties, yet they wanted a national marketplace for their stock. Because they were too small to qualify for a regular Amex listing, the ECM was the only national marketplace open to them other than the *Pink Sheets*.

However, not all of the executives were totally satisfied. As one official put it, '...the ECM was a good idea that was poorly executed. The two main problems with the execution were the poor screening and that it was oversold as a market'. One executive felt that 'Amex specialists move the stock price too far sometimes on small volume' but was overall very satisfied with the ECM.

Some of the firms that were no longer on the Amex report that they were unhappy with the loss of support from retail brokers when they moved to the Amex. One CEO states that he was 'dumbfounded' by the reaction of the retail brokerage firms: 'As soon as we did that [switched to the ECM], we lost the interest of a lot of retail brokers. They all felt they needed the extra spread to make some money on the stock. They lost interest in us because they couldn't make the hidden commission'. Another official indicates that his firm switched back to Nasdaq for three reasons: they wanted more research coverage, the firm's peer companies were on Nasdaq, and there was a 'negative prestige' about Amex.

#### 4. Other markets for small company stocks

The failure of the Amex ECM is not surprising when viewed in the historical context of the failures of other stock markets for very small companies. This section discusses attempts in the US and elsewhere to start public equity markets for small stocks.

##### 4.1. The U.S. experience

In the 19th century there were literally dozens of stock exchanges in the U.S. Virtually every major city had a stock exchange of one kind or another. These local exchanges executed orders for local residents in national stocks, and also provided a secondary market for the stocks of local companies. As communications improved, the secondary market for large companies gradually consolidated at the NYSE. This left smaller companies that did not meet the listing requirements of the NYSE or the Amex with a choice between the OTC market or the regional exchanges, most of which operated specialist auction markets similar to the NYSE. Walter (1957) notes that, by the 1950s most small

companies that met the listing standards of the regional exchanges chose to be traded in the OTC market. Most of the local exchanges died.

The surviving regionals continue to list small stocks that do not meet Amex or NYSE listing requirements. However, most of their trading volume is in NYSE- and Amex-listed stocks. According to the Securities and Exchange Commission (1994), the surviving regionals now do 97% of their business in NYSE and Amex listed stocks, rather than in their exclusive listings.

In 1962 the New York Mercantile Exchange launched the National Stock Exchange in an attempt to diversify by trading equities as well as commodities. SEC Release No. 11744 (File No. 10-53) provides some details on the National Stock Exchange. Many of the stocks previously traded on the National Stock Exchange moved to the Boston Stock Exchange, where a few of them are still listed. The National Stock Exchange, like the ECM, was an attempt to provide an exchange market for stocks too small for the Amex. At that time, such tiny stocks could trade only on the pre-Nasdaq over-the-counter market. However, the National Stock Exchange suffered almost exactly the same fate as later befell the ECM. Few stocks listed on the National, and it had a hard time gaining visibility. Newspapers would not publish its stock quotes, so it had to buy advertisements in *The Wall Street Journal* to disseminate its prices. The National also suffered from reputation effects. Its president was a former Amex president who had been forced to resign amidst a scandal at the Amex. After languishing for several years, the National finally ceased trading in 1968, ironically in the middle of one of the biggest bull markets in U.S. history.

#### 4.2. The European experience

The European experience demonstrates that problems with small stock markets are not limited to auction markets. During the 1980s, virtually every stock market in Europe established a special section for companies that were too small to meet the normal listing requirements. These junior, or 'incubator', markets used a variety of market mechanisms, usually ones similar to their parent markets. For example, London's Unlisted Securities Market was designed as a continuous dealer market, and Amsterdam's Official Parallel Market as an auction market with a specialists-like *hoekman*. Other markets used mechanisms for their small market segments that differed from those used in their primary markets: Milan's Mercato Ristretto and Paris' Marché Hors Cote used daily call auctions.

Many of these markets appeared to prosper for a short time, but ultimately they all suffered from severe illiquidity and attracted few companies or investors, as chronicled by Rasch (1994) and Bannock (1994). Amsterdam's Official Parallel Market, which used an auction mechanism similar to the Amex, closed in 1993. London closed its Unlisted Securities Market, which was a dealer market, in 1996.

Bannock (1994) notes that all of the second-tier European markets for small stocks were started by the major European exchanges, similar to the Amex ECM. The adverse selection problem has also been a serious problem with the European junior markets. Because most of the business on the major exchanges comes from trading larger stocks, the small company tiers are seen as inferior cousins of the main market. Companies move up to the main tier as soon as they qualify, just as with the ECM.

#### *4.3. Successful small capitalization stock markets*

In contrast to the dismal record of failure for many small capitalization stock markets, there have been some that have survived. In the U.S., Nasdaq now reports a higher trading volume than that of the NYSE, and over 900 Nasdaq-listed firms that could list on the NYSE choose not to. This number was estimated by using Compustat PC-Plus to search for Nasdaq-listed companies that meet NYSE listing requirements for net tangible assets, pretax income, and number of shares outstanding. Japan has created Jasdaq, a Nasdaq-like market that now lists almost twice as many stocks as the second section of the Tokyo Stock Exchange. These markets have three things in common. First, both markets grew out of pre existing over-the-counter markets. They were not just mechanisms created in the search for listings. Second, both are dealer markets. Finally, both are separate entities from the other national exchanges. By being independent, they can specialize in doing the best possible job of serving their target clientele, which might otherwise be overlooked in a market for large companies. They also have a strong financial incentive to compete to retain listings and prevent their successful firms from switching to the other markets. Thus, many of the more successful firms remain in these markets for significant periods of time, bolstering the markets' reputation.

#### *4.4. Other new initiatives for small capitalization stock markets*

Other attempts are also underway to create special markets for smaller stocks. London's Alternative Investment Market (AIM) has attracted over 260 stocks with a market capitalization over six billion pounds since its inception in 1995. The AIM operates a hybrid market that contains elements of both an auction and a dealer market. The AIM system allows for the electronic matching of orders in addition to displaying competing quotes.

European stock exchanges have launched new markets for smaller stocks in Germany (Neuer Markt, 1997), France (Le Nouveau Marché, 1996), Brussels (Le Nouveau Marché, 1997), and Amsterdam (NMAX, 1997). These markets generally combine features of both auction and dealer markets. They are also linking up in a project called Euro-NM, which will allow members of each exchange to trade the small stocks listed on the other exchanges. This linkage is

a direct response to the 1996 launch of Nasdaq, a Nasdaq-like system that is independent of the national exchanges. It is still too early to tell how these markets will do in the long term. As of October 1997, there were only 15 stocks on Easdaq, 30 on France's Nouveau Marché, and ten on Neuer Markt.

### 5. Summary and conclusions

The Amex Emerging Company Marketplace appeared to start successfully. Bid-ask spreads fell for most of the listed firms. Volume results were mixed, with reported trading volume rising substantially for some stocks but falling for others. The visibility of most of the ECM firms increased, as evidenced by more media coverage in the year after listing on the ECM. Interviews with officials of ECM-listed firms indicate that they were satisfied with the trading of their stocks on the ECM and with the services provided by Amex.

Nevertheless, the ECM failed. Several factors contributed to this failure. The organizational structure of the Amex as a membership organization meant that most Amex stakeholders had little to gain from the success of the ECM. Firms affiliated with Nasdaq market makers held almost one-fourth of the Amex board seats, and these firms could have had a vested interest in seeing the venture fail.

The ECM also suffered from the same adverse selection problem that has affected other junior markets. The successful firms graduated to the main Amex as soon as they could, leaving the unsuccessful firms on the ECM. Scandals affecting three of the original stocks damaged the ECM's reputation for monitoring the quality of its listings, one of its initial selling points. Indeed, the poor quality of the firms earned the ECM the nickname 'the submerging company marketplace'. This poor reputation contributed to the reluctance of other firms to list on the ECM, leading to a vicious circle of decline.

Because the ECM was owned by the Amex, there was no incentive for the ECM to try to prevent its listings from moving onto the Amex, which exacerbated the adverse selection problem. One thing that the Amex could have done differently would have been to encourage the successful ECM firms to stay on the ECM longer in order to build up the reputation of the ECM market. It could also have structured the ECM as a separate entity that would have had an incentive to try to retain its listings.

Even though many small firms traditionally choose a dealer market, the auction market mechanism of the ECM could have been a viable way to differentiate the ECM from Nasdaq. Indeed, interviews with senior officials of ECM-listed firms indicate that the ECM attracted firms that wanted an auction market. Perhaps modifications to its auction market similar to the new hybrid markets such as the AIM and Euro-NM would have broadened the appeal of the market.

Ultimately, the ECM was closed because it was redundant. It did not attract firms beyond those that would eventually have sought an Amex listing anyway, and thus it was not worth the direct and reputational costs of operation. This redundancy is what one would expect if firms are well informed and choose their listing rationally.

For the designers and regulators of financial markets, especially in countries that are developing new markets, the lessons are clear. Exchanges must properly screen firms to prevent scandals from destroying confidence in the market. This is especially important for a new market with a small number of stocks. Markets should seriously consider the limited liability form of ownership instead of the traditional membership organization. Policy makers seeking to establish and promote capital markets in their countries should nurture competition among markets for listings. A firm in the process of deciding its listing policy should consider, in addition to transaction costs, how a market mechanism affects the visibility of its stock.

One interesting issue for further research is to explore the reason that Nasdaq has managed to avoid the adverse selection problem common to junior markets and to retain the listings of many large companies that qualify for listing on the Amex and the NYSE.

#### Appendix A

Amex Emerging Company Marketplace Companies (see Table 10).

Table 10  
This table lists the companies that listed on the Amex Emerging Company Marketplace (ECM). Data are obtained from the Amex, the National Association of Securities Dealers, and Lexis Nexis. Original firms are those that listed when the market commenced operations on March 18, 1992. Additional firms are those that listed later. The prior market indicates where the stock traded prior to its listing on the ECM. SC indicates Nasdaq-traded firms that were not part of the Nasdaq National Market System. Market makers before ECM refers to the number of Nasdaq dealers providing quotes in the stock. NA = Not Available or Not Applicable.

Original firms	Listing date	ECM ticker	Prior market	Market capitalization (millions)	Market makers before ECM	Status in May 1995
Advanced Photonix	3/18/92	API	SC	\$10.2	6	Amex
Alta Energy	3/18/92	ALE	SC	\$17.7	9	Amex
American Pacific mint	3/18/92	DLS	SC	\$16.9	4	ECM
Audite Recognition Systems	3/18/92	ARS	SC	\$23.7	26	Amex
Cancer Treatment Holdings	3/18/92	CTH	SC	\$12.5	12	ECM
Colonial Data Technologies	3/18/92	CDT	SC	\$22.1	5	Amex
Digitran Systems	3/18/92	DGT	<i>Pink Sheets</i>	\$23.8	11	Amex
Epigen	3/18/92	EPN	SC	\$13.4	10	Delisted
Intertel Communications	3/18/92	ITR	Vancouver	\$77.3	NA	Amex
Ion Laser Technology	3/18/92	ILT	SC	\$8.7	16	Amex
Media Logic	3/18/92	TST	SC	\$11.9	10	Amex
Medphone	3/18/92	MPO	SC	\$16.3	26	Delisted
North Coast Energy	3/18/92	NCE	SC	\$13.7	6	Nasdaq
Ocean Optique Distributors	3/18/92	OPQ	SC	\$8.3	1	Nasdaq
PNF Industries	3/18/92	PNI	<i>Pink Sheets</i>	\$28.3	1	Delisted
Printron	3/18/92	PNT	<i>Pink Sheets</i>	\$51.3	10	Delisted
Professional Dental Technology	3/18/92	PRO	<i>Pink Sheets</i>	\$32.5	8	ECM
Randers Group	3/18/92	RGI	SC	\$21.0	13	ECM
Three-Five Systems	3/18/92	TFS	SC	\$5.0	4	NYSE
Top Source	3/18/92	TPS	SC	\$70.2	30	Amex
Topox	3/18/92	TPO	<i>Pink Sheets</i>	\$106.9	6	Delisted
Unique Mobility	3/18/92	UQM	<i>Pink Sheets</i>	\$18.4	8	Amex

Table 10. Continued.

Additional firms	Listing date	ECM ticker	Prior market	Market capitalization (millions)	Number of market makers	Status in May 1995
ACOI Inc	8/4/92	CCS	SC	10.1	15	ECM
Air Methods Corporation	6/2/92	ARF	SC	15.1	15	Nasdaq
Aviva Petroleum	11/14/94	AVV	London	149.5	NA	ECM
Banker's Note, Inc.	3/31/94	TBN	SC	3.6	5	ECM
Burma Gold Corporation	3/4/94	BGO	Toronto	68.7	NA	ECM
Bescorp Group Inc.	11/22/93	BGI	<i>Pink Sheets</i>	21.6	8	ECM
CEC Resources	4/24/95	CGS	Spinoff	6.6	NA	ECM
Chad Therapeutics, Inc.	8/4/93	CTU	<i>Pink Sheets</i>	37.8	9	Amex
Chesapeake Biological Laboratories, Inc.	2/10/94	PHD	<i>Pink Sheets</i>	13.4	6	ECM
Columbus Energy Corp.	7/30/92	EGY	Pacific	15.1	NA	Amex
Cornerstone Bank	3/20/95	CBN	No market	8.8	NA	ECM
Creative Comp. Appl., Inc.	8/23/94	CAP	SC	3.6	13	ECM
Crown Laboratories, Inc.	3/30/94	CLL	<i>Pink Sheets</i>	49.7	1	ECM
Encore Marketing International Inc.	4/29/93	EMI	No market	9.0	NA	ECM
Environmental Diagnostics	9/16/92	EDI	<i>Pink Sheets</i>	35.4	12	Amex
ETS International, Inc.	7/23/92	ETS	Vancouver	24.6	NA	ECM
First West Virginia Bancorp	3/8/95	FWV	<i>Pink Sheets</i>	11.4	NA	ECM
Grove Real Estate Asset Trust	6/16/94	GRE	IPO	5.6	NA	ECM
InnoVet, Inc	7/15/93	IVT	SC	24.2	13	Delsisted
Intelligent Controls	2/15/95	ITC	No market	12.3	NA	ECM
Inertline Resources Corp.	7/12/94	IRC	SC	68.2	18	ECM
Intl. Remote Imaging Systems, Inc.	6/23/92	IRI	SC	9.2	20	Amex
Leather Factory, Inc. (The)	9/27/93	TLF	<i>Pink Sheets</i>	67.5	2	ECM
Luxtec Corporation	4/20/94	LXU	SC	3.0	8	ECM
Magnum Petroleum, Inc.	11/15/93	MPM	<i>Pink Sheets</i>	12.2	6	ECM
Measurement Specialities, Inc.	4/23/93	MSS	<i>Pink Sheets</i>	15.2	11	ECM

MidSouth Bancorp, Inc.	4/19/93	MSL	No market	6.8	NA	Amex
Northern Instrument Corp	3/27/92	NIZ	<i>Pink Sheets</i>	12.3	6	Amex
NUMED Home Health Care	5/2/94	NHH	<i>Pink Sheets</i>	10.9	2	Nasdaq
OMNI Multimedia Group Inc	4/20/95	OMG	IPO	7.3	NA	ECM
PC Quote, Inc.	4/23/92	PQT	SC	6.0	6	ECM
Pyrocap International Corporation	1/10/94	PYR	<i>Pink Sheets</i>	21.2	4	ECM
Reliv International, Inc.	3/8/93	RLV	No market	59.9	NA	Amex
RF Power Products, Inc.	4/29/94	RFP	Spinoff	20.5	NA	ECM
Saba Petroleum Company	9/15/93	SAP	<i>Pink Sheets</i>	11.0	8	ECM
Scott Instruments Corp.	7/16/92	SIC	SC	8.1	12	Nasdaq
Sheffield Exploration Co., Inc.	12/14/93	SHE	<i>Pink Sheets</i>	25.8	2	ECM
Soligen Technologies, Inc.	3/10/94	SGT	Vancouver	39.1	NA	ECM
SouthFirst Baneshares	2/14/95	SZB	IPO	8.9	NA	ECM
Spectrum Signal Processing Inc.	7/29/92	SNL	Vancouver	13.4	NA	Toronto
Statordyne Corporation	6/25/93	STY	Spinoff	30.8	NA	Delisted
Surety Capital Corporation	2/23/94	SRY	SC	14.5	12	Amex
WIZ Technology, Inc.	2/2/94	WIZ	<i>Pink Sheets</i>	17.4	6	ECM

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The Honorable Bill Huizenga  
Chairman  
House Subcommittee on Capital  
Markets, Securities, and Investment  
House Committee on Financial Services  
U.S. House of Representatives  
Washington, DC 20515

The Honorable Carolyn Maloney  
Ranking Member  
House Subcommittee on Capital  
Markets, Securities, and Investment  
House Committee on Financial Services  
U.S. House of Representatives  
Washington, DC 20515

Dear Chairman Huizenga and Ranking Member Maloney:

On behalf of the two million members of the Service Employees International Union (SEIU), I urge you to oppose H.R.4015, the "Corporate Governance Reform and Transparency Act," and any similar legislation that seeks to undermine the fiduciary relationship between the pension funds in which our members participate and the proxy advisory firms used by those funds to provide the independent data and research needed to make well-informed investment decisions.

SEIU members participate in public and private-sector retirement and benefit plans, with combined assets of more than \$1 trillion. Our mission is to provide secure retirement benefits and meaningful health benefits to participants and beneficiaries and to ensure that all plan assets are used for the exclusive benefit of participants and beneficiaries.

We are deeply concerned with H.R.4015 and with efforts by the bill's proponents which will have the effect of:

- Interfering in the independent process by which pension funds gather data and research;
- Biassing in favor of corporations the research provided by proxy advisory firms and paid for by pension funds;
- Unwittingly introducing additional costs to proxy advisory firms that will trickle down to our pension funds and lower the return on investment for our members;
- Dictating a new, untested, and burdensome SEC regulatory scheme when there is already an existing proven regulatory system established under the Investment Advisers Act of 1940 and the Securities Exchange Act of 1933; and
- Inadvertently limiting competition in the proxy advisory industry by setting new barriers to market entry, thereby precluding new market entrants and/or leading smaller proxy advisory firms to exit the industry altogether.

Further, we reject the underlying assertion advanced by H.R.4015: that pension funds and other institutional investors are unwilling or unable to formulate independent investment decisions, and that we blindly follow the advice provided by proxy advisory firms. This is an irresponsible and misleading representation of the due diligence our corporate governance team and board of trustees so carefully exercise.

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May 18, 2018

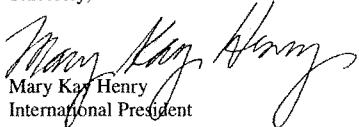
To be clear, SEIU and the National Industry Pension Fund (NIPF) have a fiduciary obligation to carry out our duties in the best interest of the plan's participants and their beneficiaries. We are accountable to our members and take this responsibility seriously.

The "solution" proposed under H.R. 4015 is to place corporations, which account to us, the shareholders, in the role of unchallenged authority figures. If enacted, the legislation would provide corporations a federally mandated right to review and effectively edit the very proxy research reports of which they are the subject – and which we commissioned and paid for. Simply put, we believe the legislation is a solution in search of a problem.

As you know, there is a retirement savings crisis in our country and there are sound legislative proposals that will help our nation's workers and their families achieve financial security. H.R.4015 is not one of them. Contrary to the claims of the bill's supporters, H.R.4015 will significantly weaken and undo existing protections that you have championed on behalf of America's workers.

For these reasons, SEIU respectfully urges you to oppose H.R.4015 and any similar legislation, including similar language that was included as part of the Financial CHOICE Act. We may add future votes on this legislation to our legislative scorecard. If you have any questions, please contact John Gray, Legislative Director, at 202-730-7669 or John.Gray@seiu.org.

Sincerely,

  
Mary Kay Henry  
International President

MKH:JG:jf  
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May 21, 2018

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The Honorable David Kustoff  
United States House of Representatives  
Washington, DC 20515

Dear Congressman Kustoff:

RE: H.R. 5054, Small Company Disclosure Simplification Act of 2018

I am writing to you as President and CEO of XBRL US, a national, nonprofit standards consortium. The mission of XBRL US is to encourage the use of public business information in a standardized format, to reduce unnecessary data processing costs, waste, and time delays; and to improve the efficiency of reporting between business, government, and the public. XBRL US is a member-driven organization, representing accounting firms, public companies, software companies, other nonprofits, data intermediaries, and service providers.

XBRL is an open, freely available, nonproprietary financial data standard which is widely used in both U.S. and non-U.S. markets.

As a standards organization, we seek to improve efficiencies in the processing of data for the entire supply chain, from the creator of the data to the consumer of the data. As such, we are in agreement with the goals of the legislation to simplify disclosure requirements and reduce the burden on small companies. We disagree however, with the XBRL exemption in H.R. 5054, which, if passed, will have the opposite impact on both public companies and investors.

**Much has changed since the bill was first introduced.**

This bill was originally proposed in 2013. At that time, concerns were raised about how many investors actually used XBRL-formatted financial company data. There were also concerns and misperceptions about the cost to issuers, of preparing XBRL. Much has changed over the past five years, establishing even more compelling reasons to *not* move forward with H.R. 5054.

**Regulators, investors, media & more, rely on XBRL data.**

**Regulators.** The Securities and Exchange Commission (SEC) uses XBRL-formatted data in their own analysis. While we have heard this anecdotally for some time, a recent rule proposal for *Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships*<sup>1</sup> states in a footnote, "This estimate is based on staff analysis of XBRL data submitted with EDGAR filings of Forms 10-K, 20-F and 40-F and amendments filed during the calendar year of January 1, 2017 to December 31, 2017." This is just one example demonstrating that computer-readable public

<sup>1</sup> <https://www.sec.gov/rules/proposed/2018/33-10491.pdf>





company data is used by regulators in analysis required to prepare rule proposals. Access to XBRL data enables faster, less expensive, more timely analysis for regulators.

**Investors and the media.** Most investors obtain financial data from commercial providers such as Thomson Reuters, S&P Market Intelligence, CalcBench, idaciti, and Intrinio, among other large and small data providers. All of these organizations use XBRL data in their database offerings to investors. Data providers offer access to data through analytical tools, data downloads, or APIs<sup>2</sup> (application program interface). One provider offers XBRL data through APIs which are accessed today by 25,000 users. Here are two examples of how the media and investors use XBRL data through commercial data providers:

- Media: <https://www.cnbc.com/2018/05/13/closer-ceo-pay-ratios-may-generate-higher-profit-per-worker.html>
- Investment research: <https://www.morganstanley.com/ideas/corporate-tax-savings>

In fact, investors want more, not less, automated data. The CFA Institute, which represents investment professionals (over 120,000 members in 140 countries), published a study in 2016 on *Data and Technology: Transforming the Information Landscape*<sup>3</sup>. In that paper, the CFA Institute states:

"... data from earnings releases remain unstructured, and XBRL versions are voluntary. We believe that requiring companies to tag their earnings releases, ... will be beneficial for investors...Some very rich data exist in the management's discussion and analysis (MD&A) section of filings. Unfortunately, the MD&A section falls outside the scope of the XBRL mandate. Requiring this section and other numeric data to be tagged would open up a trove of valuable data for all investors."

**General public.** XBRL-formatted, computer-readable data is accessed by the general public through online services and databases. For example, Google BigQuery<sup>4</sup> now carries full SEC public company datasets.

**XBRL preparation for small issuers averages \$10,000 per year.**

A study conducted jointly by XBRL US and the AICPA<sup>5</sup>, found that 69% of small filers paid \$10,000 or less for a full year of XBRL preparation. Median charges were \$8,000. Companies that paid higher amounts, did so due to complexities in their financial statements and rush charges imposed given last minute changes to the filings.

<sup>2</sup> An application program interface (API) is a set of routines, protocols, and tools for building software applications.

<sup>3</sup> CFA Institute, Data & Technology: Transforming the Financial Information Landscape, June 2016, <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v.2016.n.7.1>

<sup>4</sup> Google BigQuery: [https://console.cloud.google.com/launcher/details/sec-public-data-bq/sec-public-dataset?utm\\_source=Master%20list&utm\\_campaign=0fc0a7e7f-EMAIL\\_CAMPAIGN\\_2018\\_04\\_19&utm\\_medium=email&utm\\_term=0\\_da5920711b-0fc0a7e7f-106277581](https://console.cloud.google.com/launcher/details/sec-public-data-bq/sec-public-dataset?utm_source=Master%20list&utm_campaign=0fc0a7e7f-EMAIL_CAMPAIGN_2018_04_19&utm_medium=email&utm_term=0_da5920711b-0fc0a7e7f-106277581)

<sup>5</sup> AICPA XBRL Costs Study, December 2014, <https://www.aicpa.org/interestareas/frc/accountingfinancialreporting/xbrl/pages/xbrlcostsstudy.aspx>





An argument can be made that any cost, regardless of amount, can be considered a burden. But we question whether an additional \$10,000 per year, is enough to make a small company choose not to go public; or if it limits a company's ability to hire more staff, invest in more R&D, or introduce more new products.

**Inline XBRL eliminates dual filing and reduces company burden.**

The SEC published a formal proposal in 2017 to switch to Inline XBRL, a technical specification which provides the same benefits of computer-readability and automation afforded by XBRL, in a filing that combines HTML and XBRL into a single document. Inline XBRL will facilitate a *reduction in the preparation time and burden of filing on public companies*; and at the same time, it will *improve the quality of reported data* because there is no ambiguity between the two separate filings. We expect this proposal to go to final rule in the near future.

**Foreign private issuers now have an XBRL requirement for U.S. SEC reporting.**

In 2017, the SEC approved the IFRS Taxonomy, which triggered the requirement that all foreign private issuers that report to the SEC's EDGAR system must now do so in XBRL format.

**Structured data is more widely used beyond SEC reporting.**

Since 2013, XBRL usage has expanded far beyond SEC reporting. The U.S. Department of Energy, in partnership with industry, has developed a structured data program to reduce the soft costs of financing solar systems. This program spans broad use cases covering project finance, construction, operations, insurance, and feasibility; it has garnered broad industry support. The surety insurance industry has also embarked on a program to bring standards into the underwriting process.

Outside the U.S., the European Securities Markets Authority (ESMA) has mandated the use of Inline XBRL for public company reporting, a program that goes into effect in 2020.

**The bottom line impact of H.R. 5054**

If H.R. 5054 were to pass, 60%<sup>6</sup> of the data that is relied upon today by regulators, investors, media, and the general public, would no longer be available in computer-readable form.

**Most small companies would opt to not report in XBRL.** Despite the option to continue reporting in XBRL, that the legislation allows for small companies, most small companies would opt out of XBRL. Corporations focus on meeting compliance requirements; if not required, the assumption would be that computer-readable data is not needed. Investors, not management, should determine if computer-readable data is needed by investors.

<sup>6</sup> We estimate that, at a cutoff of \$250 million in revenue, 60% of public companies would no longer be required to file in XBRL format.





**Small companies would be at a disadvantage to large companies in attracting investment dollars.** Large companies would continue to report in a format that is easier to access, extract from, and database. Smaller companies would revert to reporting in paper-based formats (text or html) which is substantially more difficult and more expensive, to extract from, database, and analyze. Investors would demand a higher return from small companies because the cost of analyzing them is higher.

**The costs would be higher for small companies in the long run.** All companies today have an established process for XBRL preparation and reporting. H.R. 5054 would disrupt that process, and require small companies to re-establish that process in three to five years, incurring the costs of relearning how to prepare in XBRL, investigate software solutions, etc. The investment these companies have already made, would be lost.

**American taxpayers would pay for the higher cost of regulation.** First, data collection and analysis costs for regulators would increase as they would need to establish two different processes for different types of data. Second, data that is not computer-readable is substantially more expensive to process and analyze - the cost of analyzing small company data would increase significantly. Regulators would be required to perform the same job they do today, analyzing companies, but with fewer tools to perform that analysis in an efficient, cost-effective manner.

**Investors would be limited in the research they can conduct on small companies.** The lack of computer-readable data on small companies would increase the cost of analyzing these companies. It's important to note that small companies, particularly those that are considering an IPO, need historical data on small companies to determine how other startups have performed and to make informed decisions. If that data is more expensive, and more difficult to access, it hinders their ability to perform due diligence.

### **Conclusion**

The cost of XBRL preparation is not stopping companies from going public. It is not curbing small companies from making the investment in R&D and staff to grow their business.

We urge the Committee to consider the investment that has already been made by public companies, and by regulators in adopting the XBRL standard for corporate reporting. The benefits of this program are here today, in terms of reduced processing and data collection costs for regulators, investors, and other data consumers, including private and public companies conducting peer analysis.



Standards have always proved out over time to be an effective long-term solution to improve efficiency, reduce costs and waste. Standards allow the smooth flow of information that makes U.S. capital markets efficient.

We appreciate the opportunity to provide our recommendations and are available to respond to any questions the Commission may have. I can be reached at [campbell.pryde@xbrl.us](mailto:campbell.pryde@xbrl.us) or (917) 582-6159.

Sincerely,

Campbell Pryde,  
President and CEO, XBRL US, Inc.

CC:

The Honorable Bill Huizinga  
Chair, House Subcommittee on Capital Markets, Securities and Investments  
United States House of Representatives

The Honorable Carolyn B. Maloney  
Ranking Member, House Subcommittee on Capital Markets, Securities and Investments  
United States House of Representatives

Members of the House Subcommittee on Capital Markets, Securities and Investments  
United States House of Representatives

