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Subcommittee on Capital Markets, Securities, and Investment

The Cost of Being a Public Company in Light of
Sarbanes-Oxley and the Federalization of Corporate Governance

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Executive Summary

- aTyr Pharma is a clinical-stage biotechnology company based in San Diego, California. The Biotechnology Innovation Organization (BIO) represents aTyr and 1,100 other innovative biotech companies, the vast majority of which are pre-revenue small businesses.

- aTyr undertook a successful IPO in May 2015 using key provisions in the Jumpstart Our Business Startups (JOBS) Act. In the five years since the JOBS Act became law, 212 biotech companies have gone public as emerging growth companies (EGCs).

- A healthy public market is key to funding the search for innovative, next-generation medicines and maintaining the U.S. as a global leader in 21st century industries like biotechnology.

- BIO supports policies to build on the success of the JOBS Act that *increase* the flow of capital to innovative small businesses and *decrease* capital diversions from the lab to unnecessary compliance burdens.

- Costly compliance burdens that do not protect investors and external actors that do not prioritize long-term value creation can disincentivize public capital formation and make it difficult for growing biotechs to succeed on the public market.

- BIO supports the Fostering Innovation Act, which would extend the JOBS Act's Sarbanes-Oxley (SOX) Section 404(b) exemption for an additional five years for former EGCs that maintain a public float below $700 million and average annual revenues below $50 million.

- BIO supports the Corporate Governance Reform and Transparency Act, which would provide for SEC oversight of proxy advisory firms and foster accountability, transparency, responsiveness, and competition in the proxy advisory firm industry.

- BIO supports enhanced short selling transparency in order to shine a light on manipulative trading behaviors that disincentivize long-term investment in innovation.

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Testimony of John Blake

Good morning Chairman Huizenga, Ranking Member Maloney, and Members of the Subcommittee. My name is John Blake, and I am the Senior Vice President of Finance at aTyr Pharma, a clinical-stage biotech company based in San Diego, California.

aTyr is a small business with just 66 employees, all of whom are dedicated to our ongoing search for therapies to treat a variety of severe and rare diseases using our knowledge of Physiocrine biology, a newly discovered set of physiological pathways. By focusing on immune pathways in disease, we believe our therapeutic candidates have the potential to restore patients to a healthier state, achieve homeostatic balance, and ultimately lead to improved clinical outcomes. To date, the company has generated three innovative therapeutic candidate programs in three different therapeutic areas. Our first product candidate is designed to treat rare muscular dystrophies with an immune component. Our second therapeutic candidate is a potential therapeutic for patients with rare pulmonary diseases. Finally, our third program is a preclinical research program in a third therapeutic area.

aTyr's story is mirrored across the biotech industry. The Biotechnology Innovation Organization (BIO) represents aTyr and over 1,100 other innovative companies making similar progress on the path toward medical breakthroughs. These groundbreaking companies – over 90% of which are pre-revenue small businesses – are at the forefront of an all-consuming effort to combat and cure diseases, treat patients and provide relief to their families, and save lives in the U.S. and around the world.

In order to fund the decades of research that it takes to develop a single breakthrough medicine, growing biotechs turn to a range of both private and public investors. Because biotech R&D is undertaken without the benefit of product revenue, small business innovators are entirely dependent on external capital to finance the $2 billion biotech development pathway. Capital formation, to put it lightly, is of paramount importance in our industry.

In 2015, aTyr raised $86 million through an IPO to fund Phase 1b/2 clinical trials for our first product candidate. Before our IPO, we had raised $172 million in venture financing over 10 years, for a grand total of over $250 million raised since 2005 – and we are likely still years away from presenting a drug candidate to the FDA for final approval, a time period during which we will remain steadfastly free of product revenue.

The prodigious capital requirements of cutting-edge biotech research, as exemplified by aTyr's financing story, make the work of the Subcommittee extremely vital to the industry's success – and, ultimately, to the health and well-being of the patients we serve. The Jumpstart Our Business Startups (JOBS) Act, passed five years ago with bipartisan support in both the House and Senate, is a shining example of the impact that targeted policymaking can have on biotech capital formation. The law has supported more than 200 biotech IPOs through its smart combination of increased access to capital and a decreased regulatory burden for growing companies. I am encouraged that the Subcommittee is considering ways to build on the JOBS Act's successes by continuing to support the growth of small business innovators on the public market.

Though the public capital markets are an essential component of the biotech financing ecosystem, roadblocks that decrease the capital potential of an offering, reduce long-term liquidity and investor confidence, or distract a company from its core mission have the potential to deter or delay necessary offerings. For instance, burdensome regulations like

Section 404(b) of Sarbanes-Oxley (SOX) divert innovation capital away from the lab, while external forces like proxy advisory firms and manipulative short sellers increase costs and deter vital investment. These barriers, and others, reduce the viability of the public market as a capital formation option for emerging biotechs, ultimately harming issuers, investors, and patients alike. Given the importance of public capital formation for life-saving innovation, I am hopeful that the Subcommittee can take action to enact regulatory and corporate governance policies that bolster America's world-leading capital markets and prioritize both capital formation and resource efficiency for innovative small businesses.

SOX 404(b) and the Fostering Innovation Act

Regulatory costs are a key incentive for companies to stay private rather than brave the public markets. Despite the positive economic benefits of IPOs (namely, a sharp increase in job creation), many private small businesses choose to deter or delay their offering because of the high costs of being a public company. For companies like aTyr that do not have the luxury of remaining private and must go public in order to fund our research, expensive regulatory requirements siphon innovation capital from the lab, diverting funds from science to compliance on a quarterly and annual basis. Disclosure burdens and other compliance metrics obviously offer protections for investors, and BIO strongly supports appropriate investor safeguards. However, costly one-size-fits-all requirements do not benefit companies or their investors, and BIO supports efforts to institute right-sized regulations that do not impose unnecessary expenses on growing innovators.

As the Subcommittee examines the impact of SOX in light of its 15th anniversary, I would encourage it to consider ways to reduce the cost burden of the law – and particularly of Section 404(b), which has a uniquely damaging impact on smaller biotechs. The requirements of Section 404(b) provide important protections for investors in large, multinational, revenue-generating corporations, but applying the same requirements to biotech small businesses with few employees (most of whom are scientists and medical professionals) diverts funds from and ultimately delays scientific progress.

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. The most direct policy impact of the JOBS Act has been the five-year exemption from Section 404(b), a vitally important reform that allows small public companies to choose how to allocate scarce investor funds. This optional allowance has been utilized by virtually all of the emerging growth companies (EGCs) in our industry, with the support of our investors.

Biotech investors demand information about the growth-stage companies in which they invest – and spend countless hours learning as much as they can about the company's science, the diseases it is treating, the patient population its drug candidates will target, its FDA approval pathway, and a hundred other variables that will determine the company's ultimate success or failure. Indeed, the testing-the-waters process created by the JOBS Act has been so successful for the biotech industry because it allows companies a platform to disseminate *more* and *more detailed* information to potential investors. But the information that these investors want and need does not align with what is required by SOX – and yet virtually all biotechs are subject to this one-size-fits-all mandate that can cost them over $1 million per year once their EGC exemption expires.

Thanks to the JOBS Act, aTyr has been able to spend dollars on R&D and job creation over the last two years that otherwise would have been earmarked for SOX compliance, and we still have three years of IPO On-Ramp eligibility remaining. However, it remains the case

that the biotech development timeline is a decades-long affair. It is extremely likely that aTyr will 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. At the dawn of year 6 on the market, we estimate that our compliance costs will nearly double, an increase that will be paid for with valuable innovation capital that would be better-used covering clinical trial and research expenses.

Most biotechs that went public under the JOBS Act will find themselves in the same predicament in the next several years – still reliant on investor capital to fund their research, but facing a full-blown compliance burden identical to that faced by commercial leaders and multinational corporations.

To address this problem, Reps. Kyrsten Sinema (D-AZ) and Trey Hollingsworth (R-IN) have introduced the Fostering Innovation Act (H.R. 1645), which would extend the JOBS Act's SOX 404(b) exemption for certain small companies beyond the existing five-year expiration date. This important bill recognizes that a company that maintains the characteristics of an EGC but has been on the market beyond the five-year EGC window is still very much an emerging company.

The Fostering Innovation Act would apply to former EGCs that have been public for longer than five years but maintain a public float below $700 million and average annual revenues below $50 million. These small businesses would benefit from an extended SOX 404(b) exemption for years 6 through 10 after their IPO. The additional five years of cost-savings would have the same impact as the first five years – emerging companies would be able to spend investor capital on growing their business. In the biotech industry, that means small business innovators can remain laser-focused on the search for breakthrough medicines.

If a company eclipses $50 million in average annual revenues, its full SOX 404(b) compliance obligations would kick in. The Fostering Innovation Act does not grant a carte blanche exemption – it is targeted specifically at pre-revenue companies, because revenue is the key indicator of company size, and of the ability to pay for expensive compliance obligations like Sarbanes-Oxley. Maintaining the JOBS Act's public float test of $700 million while drastically lowering the revenue test from $1 billion to $50 million limits the Fostering Innovation Act to a specific universe of truly small companies – instituting a company classification regime for years 6 through 10 post-IPO that accurately reflects the nature of small businesses while also supporting their growth.

Under current law, small, pre-revenue companies are often required to file the same reports as revenue-generating, profitable multinational corporations. Under the Fostering Innovation Act, these emerging companies will save millions of dollars that can be utilized to fund groundbreaking R&D and life-saving medical research. BIO commends Reps. Sinema and Hollingsworth for their leadership on this vital legislation, which last year was approved on a bipartisan basis by the House Financial Services Committee and then passed by the House via voice vote. I am hopeful that the Subcommittee will support the Fostering Innovation Act in order to enhance capital formation and company growth at America's pre-revenue businesses.

Proxy Advisory Firms and the Corporate Governance Reform and Transparency Act

Biotech companies value shareholder input, and strive to implement corporate governance policies that place shareholder value at the forefront of our decision-making processes. At aTyr, we place an emphasis on long-term value creation for investors – a vital metric of success given the extended nature of biotech R&D. During the development process, there

are frequently scientific setbacks unrelated to the quality of company management or the corporate governance policies we have in place. Indeed, good and stable management teams in our industry have, time and again, used the knowledge gained from these short-term delays to ultimately develop life-changing therapeutic innovations – delivering exceptional long-term shareholder value in the process.

The ups and downs inherent to groundbreaking scientific advancement, combined with the general volatility of stock prices in our industry, can at times create a disconnect between the creation of shareholder value and the external recognition of it. Biotech management teams put considerable energy into communicating the company's progress to shareholders, and industry investors generally understand the nature of biotech investing. Everyone involved is in it for the long haul. As such, outside actors that place an emphasis on short-term metrics, often at the expense of long-term value creation and patient impact, can be particularly disruptive. Recent industry experiences with proxy advisory firms underscore the divide between short- and long-term approaches to shareholder value creation, and highlight the need for oversight of the proxy firm industry.

Despite their significant influence on emerging companies, proxy advisory firms (the universe of which is functionally limited to just two firms) generally refuse to engage in a productive or transparent dialogue with smaller issuers, instead relying on one-size-fits-all recommendations that do not take into account a company's or its shareholders' unique circumstances. Furthermore, the conflicts of interest inherent in the business model of those firms which engage in business consulting in addition to providing proxy recommendations raise serious concerns.

Proxy advisory firms pose a particularly acute risk for growing innovative companies like aTyr. Emerging biotechs 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 business. These one-size-fits-all recommendations, developed with minimal input from the company, do not accurately reflect the true nature of an emerging biotech, and are often focused on quarterly metrics rather than long-term scientific advancement and shareholder value creation.

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. This issue is exacerbated by the fact that the consulting arms of the firms also put pressure on smaller issuers, raising significant conflict of interest concerns. Dealing with issues created by proxy firms' beliefs about corporate governance can distract company management and divert vital resources from the ultimate mission of any biotech – delivering groundbreaking treatments to patients.

BIO believes that proxy advisory firms should be more transparent and open to input in their standard-setting processes, 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.

In the 114th Congress, Rep. Sean Duffy (R-WI) and then-Rep. John Carney (D-DE) introduced the Corporate Governance Reform and Transparency Act, which would provide for SEC oversight of proxy advisory firms. By ensuring that firms have processes in place to engage in a dialogue with smaller issuers, the legislation would make it more likely that a firm's recommendation is relevant to a company's business model and allow small businesses to focus on long-term growth. Further, the bill's regulation of conflicts of

interest would ensure that the proxy firms are actually acting in the best interests of shareholders.

BIO strongly supports the Corporate Governance Reform and Transparency Act, which last year passed the House Financial Services Committee on a bipartisan basis. Passage of legislation to regulate proxy firms would be a welcome change from a status quo that forces companies to contort themselves to satisfy proxy advisors rather than making decisions in the best interests of the company and its shareholders. BIO applauds Rep. Duffy for his continued interest in this important bill, and we are hopeful that the Subcommittee will support it in the 115th Congress.

Short Selling Transparency

As I have discussed, long-term value creation is key to biotech capital formation – shareholders often hold their investment for more than a decade before seeing a return. While most long-term investors can hold out through short-term ups and downs, growing biotechs also face concerted efforts from manipulative short sellers that impact shareholder value far more than the day-to-day realities of scientific uncertainty. These deliberate trading strategies can make long investors skittish about providing the capital necessary to fund the decades-long, billion-dollar development pathway intrinsic to life-saving research.

The unique business model of groundbreaking innovation leaves emerging biotechs particularly vulnerable to stock manipulation via abusive short selling strategies. The high-stakes nature of their research (both the uncertainty associated with scientific advancement and their limited portfolio of product candidates), combined with thinly traded stocks and strict FDA rules about disclosing the status of ongoing clinical trials, 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.

Company management has a fiduciary duty to protect shareholders, but the lack of transparency around short positions makes it exceedingly difficult to police short manipulation effectively. This consistent risk of manipulation, and the lack of information available that would allow companies to combat it, disincentivizes the long investment necessary to fund life-saving biotech R&D.

BIO believes that increased short transparency, designed to complement the existing long disclosure regime, would shine a light on manipulative behaviors, allow market participants to make informed trading decisions, and ensure equitable rules for all types of investments. Specifically, we would support required disclosures of investors taking significant short positions, modeled after the beneficial ownership disclosure obligations in SEC Regulations 13D and 13G.

The current disclosure regime for long positions exists to provide information regarding persons that may have potential influence over, or control of, an issuer. Investors taking short positions, on the other hand, face no public disclosure requirement, despite the

significant influence they exert on issuers. Their power stems not from voting rights, but rather from the ability to engage in manipulative trading behaviors that harm growing companies and disincentivize long-term investment in 21st century innovation and job creation – yet there is not a parallel disclosure regime for the reporting of short positions.

BIO sees no public policy justification for this disparity between the disclosures required of long and short investors. Both groups are making predictions based on the risk and/or reward a given company presents, but only one group is required to disclose its holdings and transactions. We have clearly seen that this information asymmetry can be harmful to emerging issuers and their investors.

Notably, BIO supports a short disclosure regime that is *complementary*, rather than identical, to the existing long disclosure requirements. The long disclosure trigger in Regulation 13D (5% of a class of an equity security) is unlikely to capture short manipulation for the simple reason that few short sellers take a large enough short position to cross the 5% threshold – yet still find it easy to manipulate a company's stock even if they are short far less than 5%. BIO would support either a lower disclosure trigger or a standard based on a different metric than outstanding shares (for example, trading volume could be a more appropriate measure given that the depressive effect of short sales on a stock price is largely a function of the volume and frequency of short transactions relative to the overall securities transaction volume).

Issuers, investors, and patients are all impacted by the current lack of short transparency. A commonsense disclosure regime for short positions would shine a light on manipulative practices while giving investors and companies the information they need to make informed market decisions.

Conclusion

The bipartisan JOBS Act showed that targeted policymaking designed to support job creation and capital formation at small businesses can have a dramatic real world impact. The many JOBS Act success stories in the biotech industry, including aTyr, are attributable to the one-two punch at the core of the law: First, it allows small companies enhanced access to investors, increasing the capital raising potential of an offering. It then provides them with targeted relief from costly regulatory burdens, decreasing the amount of capital diverted from research. This combination is critical for biotech innovators, and provides a useful model for the Subcommittee to follow as it considers further ways to support the growth of small public companies.

Unlike in many other industries, emerging biotechs are almost always looking to go public given the capital-intensive nature of our research. But that does not mean that conducting an IPO or staying a public company is an easy choice. Growing public biotechs face a constant array of costly regulatory burdens and short-term-oriented external actors – both of which distract company resources from the mission of delivering cures and treatments to patients in need. Congress can support these small business innovators by enacting legislation that enhances the capital formation ecosystem, reduces regulatory burdens, and incentivizes long-term funding for the next generation of breakthrough medicines.

I appreciate your dedication to these vital issues, and I look forward to supporting your work in any way I can.