The JOBS Act at Five:
Examining Its Impact and Ensuring the Competitiveness of the U.S. Capital Markets

Testimony by
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Subcommittee on Capital Markets, Securities, and Investment
Committee on Financial Services
U.S. House of Representatives

The Honorable Bill Huizenga, Chairman
The Honorable Carolyn Maloney, Ranking Member

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Protecting Small Business, Promoting Entrepreneurship

Chairman Huizenga, thank you for hosting this important hearing today on the JOBS Act and the competitiveness of U.S. capital markets. The Small Business & Entrepreneurship Council (SBE Council) is pleased to submit this testimony.

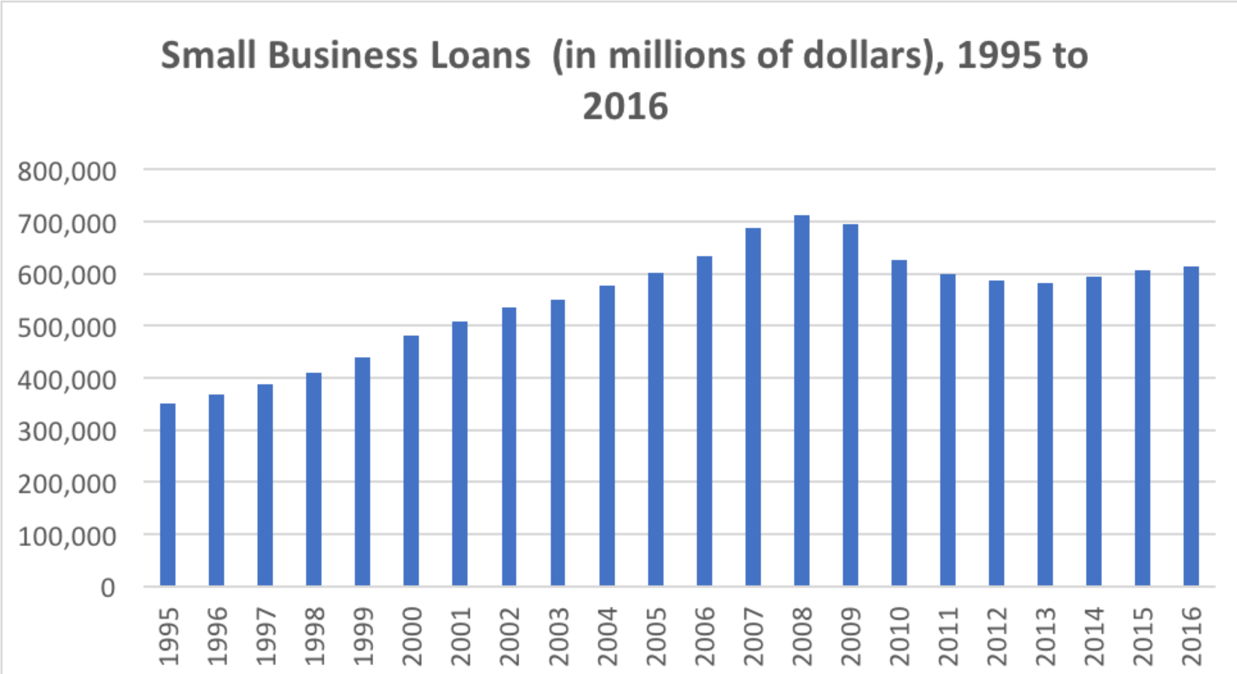
My name is Raymond J. Keating, and I am the chief economist for SBE Council, the author of several books, including *Unleashing Small Business Through IP: The Role of Intellectual Property in Driving Entrepreneurship, innovation and Investment*, and for a decade, I was an adjunct professor teaching MBA students in the business school at Dowling College.

SBE Council is a nonpartisan, nonprofit advocacy, research and training organization dedicated to protecting small business and promoting entrepreneurship. With some 100,000 members and 250,000 small business activists nationwide, SBE Council is engaged at the local, state, federal and international levels on policies that enhance competitiveness, and improve the environment for business start-up and expansion, and economic growth.

Small Business Challenged on Raising Financial Capital

Gaining access to financial capital – whether via equity or debt – is essential to the creation and growth of businesses. At the same time, access to capital remains a major challenge for entrepreneurs starting up and building enterprises across our economy. And since the financial crisis and Great Recession, it arguably has become more difficult to access capital from institutional banks and various capital market players.

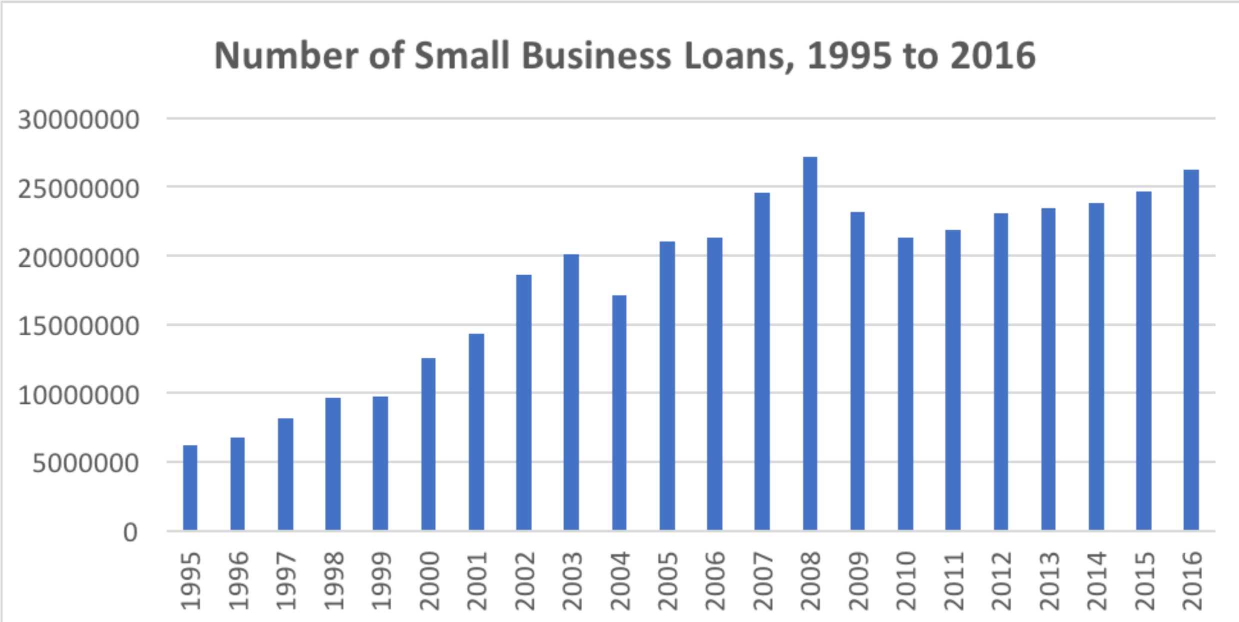
Consider the trend in bank small business loans (less than $1 million) over the past several years (as highlighted by the graph below). The value of small business loans outstanding hit a high of $711.5 billion in 2008, and subsequently fell for five straight years (to a recent low of $581.9 billion in 2013), with growth subsequently resuming in the following three years. The 2016 level came in at $614.2 billion, which is roughly where the small business loan level was in 2005-06. So, in effect, we've seen no growth for a decade.



Data Source: Federal Deposit Insurance Corporation, Quarterly Banking Profile

It's also worth noting that the small business share of commercial and industrial loan value outstanding registered, for example, 33 percent in 1995, 35 percent in 2004, and 30 percent in 2007. As of the second quarter of 2015, however, it had fallen only 20 percent, and has remained there since. Looking at nonfarm nonresidential loans, the small business share came in at 52 percent in 1995, and had declined to 39 percent in 2007. At the end of 2016, the small business share further declined to 21 percent.

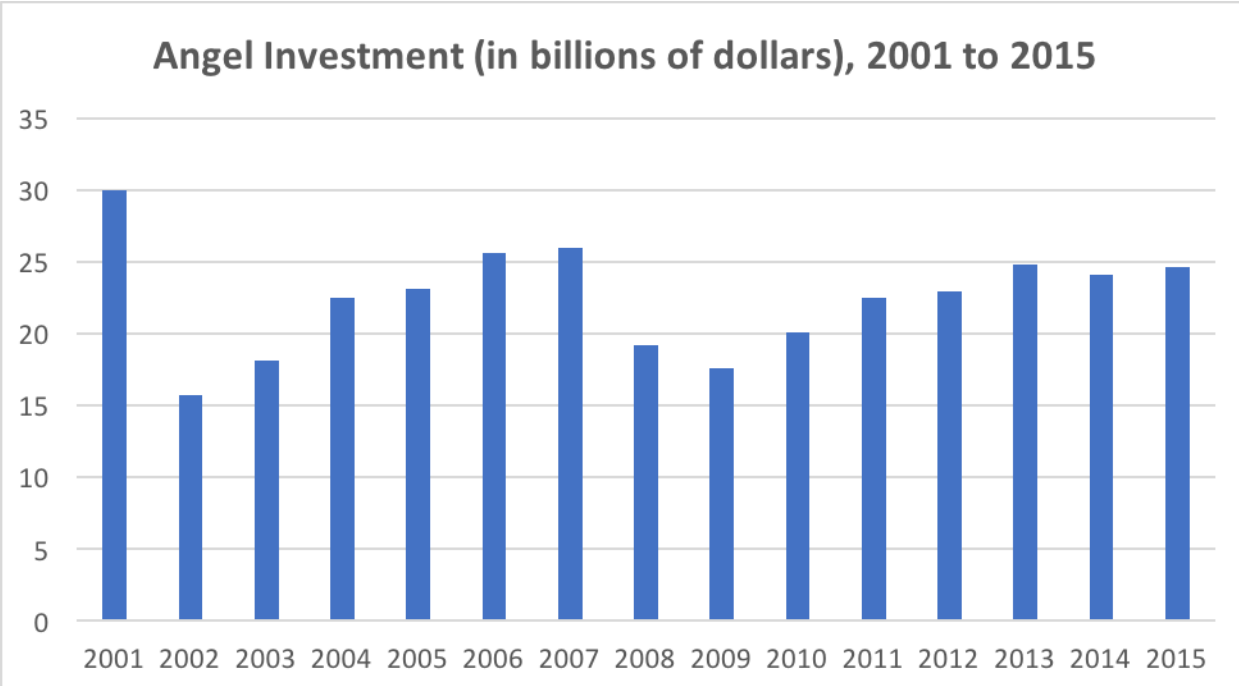
As for the number of small business loans, these rose steadily up to 2008 (hitting 27.1 million in 2008 compared to 6.3 million in 1995), and subsequently declined and struggled to recover. (See graph below.) A recent step up in growth in 2015 and 2016 meant that the number of small business loans hit 26.3 million in 2016 – which, however, was still below the 2008 level.



Data Source: Federal Deposit Insurance Corporation, Quarterly Banking Profile

Meanwhile, on the equity side, angel investment is a critical source of funding for start ups and early-stage businesses. Unfortunately, the story has been troubling in recent years. According to the Center for Venture Research at the University of New Hampshire, after a big drop in 2002, coinciding with the aftermath of the 2001 recession (as well as the post "tech bubble"), growth resumed from 2003 through 2007, with angel investments increasing from $15.7 billion in 2002 to $26 billion in 2007. With the recession, a big drop-off followed in 2008 and 2009, and subsequent growth has been underwhelming or, in effect, nonexistent. For all of 2013, angel investment registered $24.8 billion, followed by $24.1 billion in 2014 and $24.6 billion in 2015. And the center offered the following description for the first two quarters of 2016 (latest available in "The Angel Investor Market in Q1Q2 2016: Caution Prevails" by Jeffrey Sohl, director, Center for Venture Research):

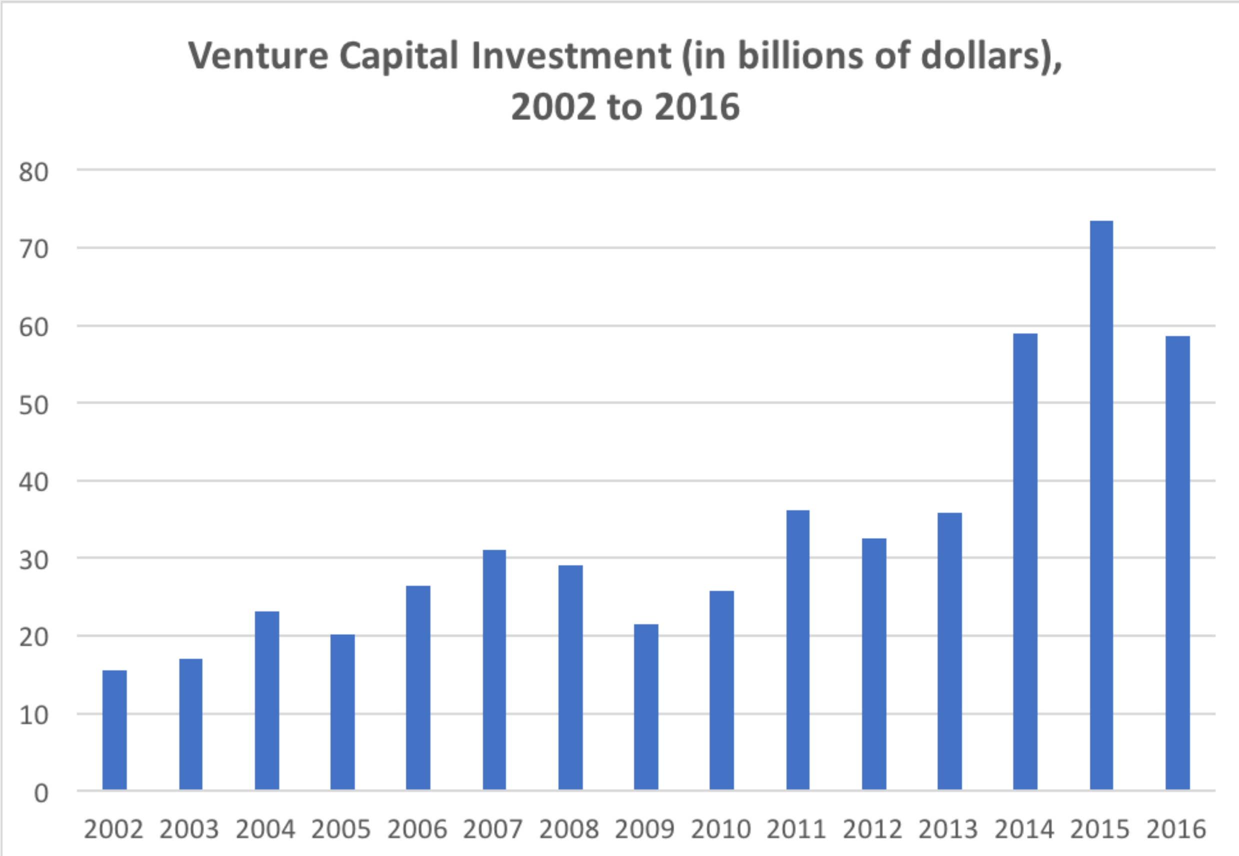
> "Angels continue to reduce their investment allocations in the seed and start-up stage, with 27% of Q1,2 2016 angel investments in the seed and start-up stage. The trend has been a steady decrease in seed and start-up distributions when compared to similar periods in 2014 and 2015. In the first half of 2014 36% of the angel deals where in the seed and start-up stage followed by 31% in the first two quarters of 2015. There was an accompanying shift to early stage (post seed and start-up) financing to 53% of investments in Q1,2 2016 from 51% in Q1,2 2015 and 42% in the first two quarters of 2014. Expansion stage financing also increased from 15% in Q1,2 2015 to 19% in Q1,2 2016. Historically angels have been the major source of seed and start-up capital for entrepreneurs and while that stage remains over a quarter of angel investments, angel seed/start-up investments have remained consistently below the pre-2008 peak of 55%. This steady decline in allocations signifies that there continues to be a need for seed and start-up capital for both new venture formation and job creation."



Source: Center for Venture Research at the University of New Hampshire

It also is worth taking a look at the recent trend in venture capital investment. Venture capital is not really about start-up or early-stage investment, but it plays a vital role in subsequent growth stages. Venture capital is about firms or funds that invest in enterprises that have reached a certain level of development, often after reaching the "proof of concept" stage. The trend in venture capital in recent years has been similar to what has already been noted in other areas – such as growth from 2002 to 2007, followed by a big drop off in 2008 and 2009, followed by uneven growth from 2010 to 2013. However, venture capital experienced welcome strong growth in 2014 and 2015, followed by a notable decline in 2016. As explained in the PWC/Global Trends *MoneyTree Report* for Q4 and Full-year 2016:

> "Investor caution prevailed as Q4'16 saw a 14% slowdown in deals and 17% decline in total funding from the prior quarter. 2016 saw a total of $58.6B invested across 4,520 deals, down 20% and 16%, respectively from 2015."



Source: PWC/Global Trends

So, to sum up, the value and number of traditional small business loans are still down from pre-recession levels. Angel investment also remains down from its 2008 level, while also experiencing stagnation over the last two years. Also, venture capital has shown the most life post-recession, but the decline in 2016 is troubling. (By the way, it should be noted that all of the trends cited above are quoted in nominal dollars, so when inflation is added into the mix, any growth trend is narrowed.)

These trends speak to primary phenomenon. First, it is about reduced levels of entrepreneurship. As noted in an August 2016 SBE Council report – "Gap Analysis #3 - Entrepreneurship in Decline: Millions of Missing Businesses" – according to various measures of the number of businesses, the U.S. economy has suffered an estimated gap or shortfall of anywhere from 867,000 to 4.8 million businesses in the U.S. economy. For example, if we look at incorporated and unincorporated self-employed, and employer firms as shares of the relevant population, we see a significant gap in the number of businesses compared to where we should be. Indeed, these numbers point to some 3.7 million missing businesses in the U.S. in 2015. Reduced levels of entrepreneurial activity – due to an assortment of factors, but largely a policy environment hostile to entrepreneurship and investment – naturally means reduced loan and investment demand.

Second, these trends speak to the struggles for entrepreneurs to gain access to the financial resources needed to start up and grow.

Why does any of this matter? Quite simply, entrepreneurship is the engine of innovation, productivity and income growth, and job creation. And entrepreneurship depends upon the willingness and ability of investors and lenders to supply investment and credit.

Consider the broadest measure of our economy. Since the recession officially ended in mid-2009, real GDP growth has averaged only 2.1 percent during this period of recovery/expansion. That compares miserably to the average real growth rate of 3.1 percent prevailing over the past six decades, and an average real rate of 4.3 percent during periods of recovery/expansion. That is, on average, economic growth has been running at less than half of where it should be. The reason for this woeful growth largely is anemic private investment. Consider that private fixed investment peaked in the first quarter of 2006, declined dramatically through the fourth quarter of 2009, and only climbed back to the first quarter 2006 level in the fourth quarter 2014 – more than eight years of no growth. And the fourth quarter 2016 level (most recent) was only 3.7 percent higher than the first quarter 2006 – again, there's been barely any growth in private fixed investment in the U.S. economy for more than a decade. In addition, for all of 2016, private nonresidential fixed investment declined versus the previous year for the first time since 2009.

Make no mistake, entrepreneurship, business expansion, investment and economic growth are all tied together.

Therefore, providing small businesses with more options or avenues to expand access to financial capital is a clear positive for the economy.

The JOBS Act

In response to broad concerns about business startup levels and the significant challenge entrepreneurs continued to experience accessing capital, Congress passed and President Barack Obama signed the JOBS Act into law in April 2012. The overwhelmingly bipartisan bill, strongly supported by SBE Council, focused on helping to stimulate the U.S. economy by promoting capital formation.

Two important parts of the JOBS Act focused on opening up new avenues for individuals to invest in entrepreneurial ventures, such as via crowdfunding. Title II of the JOBS Act allowed "accredited investor" crowdfunding and Title III crowdfunding for everyone else, if you will. Title II allows for, as phrased by the SEC, a company to "broadly solicit and generally advertise" a private offering to "accredited investors." Meanwhile, Title III "provides an exemption from registration for certain crowdfunding transactions," with a business limited to raising "a maximum aggregate amount of $1 million in a 12-month period," while investors having annual income or net worth of less than $100,000 are limited during a 12-month period to the greater of $2,000 or 5 percent of the lesser of annual income or net worth (if both annual income and net worth top $100,000 then the limit is 10 percent of the lesser of income or net worth).

As for investment under Title II, according to Crowdnetic's report "Title II Turns Three: Crowdnetic's Annual Title II Data Analysis for the period ending September 23, 2016":

> "Through CrowdWatch— Crowdnetic's centralized platform for the analysis of private offerings conducted online—Crowdnetic has aggregated and normalized 6,613 Title II offerings from 16 leading platforms since September 23, 2013. These offerings have generated more than $1.47 billion in capital commitments in the aggregate. Although the number of new offerings has declined from year to year, the annual aggregate amount of recorded capital commitments has increased each year, with more than 40% of the 3-year total having been recorded during the previous 12-month period."

Specifically, the number of new offerings came in at 4,712 in year one, 1,351 in year two, and 550 in year three, while annual recorded capital commitments registered $385.8 million in year one, $484.2 million in year two, and $603.4 million in year three.

Meanwhile, according to Crowdfund Capital Advisors, since Title III launched in May 2016 (unfortunately it took four years to implement this section of the JOBS Act), capital commitments registered $29.7 million as of March 10, 2017.

Reforms and Improvements to Fully Leverage JOBS Act Crowdfunding

Even given the significant and positive changes being brought about for entrepreneurs and investors with the JOBS Act, areas in need of improvement always exist, including government over-regulating or placing too many limitations on the ability of entrepreneurs to gain access to capital, and/or on investors' abilities to make investments in entrepreneurial ventures.

For example, the following reforms would expand opportunities for entrepreneurs and investors when it comes to crowdfunding:

• Crowdfunding opportunities should be expanded for businesses of different sizes and stages, and therefore, the limit of raising $1 million during a 12-month period under Title III crowdfunding should be raised, for example, to $5 million.

According to Sherwood Neiss and Jason Best, co-founders and principals of Crowdfund Capitol Advisors (and SBE Council members) writing in Crowdfundinsider.com on November 11, 2016 ("How Donald Trump Can Leverage Crowdfunding Under Reg CF to Double GDP Growth"):

> "More capital means more ability for these entrepreneurs to hire Americans. Our research found that 2.2 jobs are created within the first 90 days after a company is successful with a securities-crowdfunding campaign."

• Expand the ability of investors to invest by shifting income/net worth limits.

As noted earlier, investors having annual income or net worth of less than $100,000 are limited during a 12-month period to the greater of $2,000 or 5 percent of the lesser of annual income or net worth (if both annual income and net worth top $100,000 then the limit is 10 percent of the lesser of income or net worth). The application of the percentages should be altered from “lesser of income or net worth” to the greater of income or net worth.

• Clarify that funding portals cannot be held liable for material misstatements and omissions by issuers, unless portals are guilty of fraud or negligence.

This assurance would reduce unnecessary risks for crowdfunding portals. Again, Neiss and Best explained:

> “Reduce bureaucracy and create a statutory safe harbor for online platforms, similar to what traditional broker dealers have had for decades. As it currently stands, platforms are liable for any false statements made by an issuer. While that might seem logical, a platform is just a technology-enabled way for entrepreneurs to connect with investors. The platforms do not have the domain expertise of the issuer’s company or technology and cannot verify the accuracy of all statements made by issuers. Part of the role of the crowd (and the job that investors like Angels and VCs perform) in crowdfunding is to do the diligence and verification of a company’s offering documents. This role should remain with the investors and not be the role or liability of the platform. By creating this safe harbor, more platforms will emerge to support different verticals of the market (i.e.: Veterans, Women and Minority business, etc). More platforms in more vertical means more businesses and more economic output.”

• Neiss and Best call for allowing syndicate/lead investor models for crowdfunding.

They noted: “Increase efficiencies and allow ‘syndicate/lead investor models’ for all forms of crowdfunding. Today, accredited investors can do this (sites like AngelList have used this method very successfully). We believe that all investors should have the option to use investment methods that enable a lead investor to validate a company’s valuation, strategy and investment worthiness. Traditionally, angel investors have operated in groups and often follow a lead. This recommendation puts all investors on a level playing field and will allow more capital to flow into the space which will further economic development.”

• Vincent Bradley, CEO and co-founder of FlashFunders in a January 16, 2017, Entrepreneur.com article, also pointed out the following items that can be improved:

- “Reg CF [Regulation crowdfunding] requires that businesses raising more than $500K have GAAP Standard financials prepared and ready to share. While it’s important to provide potential investors with transparency into your business, the reality is that early stage companies generally don’t have GAAP financials prepared. And spending $5-10K on a CPA to prepare them is excessive.

- “Reg CF requires businesses to file a Form C with the SEC before they can solicit investors. A Form C is a 25-page document that can require upward of 50 hours of work to complete. You’re going to want a lawyer to review and help prepare some of it, so expect anywhere from $1-5K in legal costs, which most startups don't have."

- 12(g) rule "stipulates that if a business uses Reg CF to successfully raise capital and crosses $25 million in assets, they'll be required to begin reporting as a public entity. This potentially creates a situation where a company could be forced to go 'public' whether they're ready to or not."

Conclusion

Few better understand the costs of government regulations, rules and restrictions than entrepreneurs and small businesses owners, as they are on the front lines of having to deal with the burdens of government red tape and costs. That is the case not only when it comes to regulations that impact day-to-day operations, but also when government rules impede their ability to access needed financial capital.

In many ways, the U.S. truly does have the "gold standard" of financial capital markets. But the threat always looms that government overreach will undermine the efficacy of these markets. Regulatory policy needs to protect against fraud and abuse, but it also needs to reflect the reality that free markets provide the foundation upon which entrepreneurship, investment, innovation and business can flourish, thereby providing a breathtaking array of goods and services that improve all of our lives in seemingly countless ways.

It is vital that financial regulation recognize these realities, the transparency that technology has imposed upon the system, and be built on a respect to free enterprise. Thank you for your time and the opportunity to provide testimony today. I look forward to our discussion and your questions.

About Raymond J. Keating

Raymond J. Keating serves as chief economist with the Small Business & Entrepreneurship Council (SBE Council), a nonpartisan, nonprofit advocacy, research and training organization dedicated to protecting small business and promoting entrepreneurship.

He writes, speaks and testifies on a wide range of issues affecting the entrepreneurial sector of the economy. In addition to assorted policy papers and reports, he pens the weekly analyses on SBE Council's "Small Business Insider" blog at www.sbecouncil.org covering areas such as taxation, regulation, the state of the economy, energy, capital and credit issues, state policy and economic developments, telecommunications, and much more.

Keating also writes a regular column for RealClearMarkets.com, and wrote a newspaper column for *Long Island Business News* for seven years, previously for *Newsday* on Long Island for more than 11 years, and for the *New York City Tribune* for two years.

Keating has written five nonfiction books – *Unleashing Small Business Through IP: The Role of Intellectual Property in Driving Entrepreneurship, innovation and Investment* (2016 revised edition), *"Chuck" vs. the Business World: Business Tips on TV* (2011), *U.S. by the Numbers: What's Left, Right, and Wrong with America State by State* (2000), *New York by the Numbers: State and City in Perpetual Crisis* (1997), and *D.C. by the Numbers: A State of Failure* (1995). He also has contributed essays to four other books. For good measure, Keating is a novelist. He has written six thrillers in his Pastor Stephen Grant novels series – *Warrior Monk* (2010), *Root of All Evil?* (2012), *An Advent for Religious Liberty* (2012), *The River* (2014), *Murderer's Row* (2015), and *Wine Into Water* (2016).

Keating has written hundreds of articles, with pieces published in such periodicals as *The Washington Post, The Wall Street Journal, The New York Times, Boston Globe, National Review, Investor`s Business Daily, Chicago Tribune, The Washington Times, New York Post, Daily News,* and many more.

In addition, for a decade, Keating was an adjunct professor in the Townsend Business School at Dowling College, where he taught a wide variety of courses in the MBA program, including Advanced Innovation and Entrepreneurship, International Business, Public Sector Economics, and Organizational Theory.

His areas of expertise include taxation; federal, state and city budget issues; monetary policy; regulation; energy policy; supply-side economics; the economics of sports stadiums and arenas; the U.S. economy; trade; intellectual property and property rights in general; and a host of other small-business issues.

Keating holds an MA in economics from New York University, an MBA in banking and finance from Hofstra University, and a BS in business administration and economics from St. Joseph's College.