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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

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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.[1] 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

[1] Launched in 2015 by five leading buyside firms, Healthy Markets has since expanded to include sixteen buyside 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.

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.[2] 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.[3]

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.[4] 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

[2] 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.

[3] 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.

[4] 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=429022106021126126083112126071001120116034070035005055097071030030066093066073001077124004061061006108028027117118125079097025008087047000081003016112115126126006081077040020099110090124072126123100097081112069001066098074092113123085067090006085099&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.[5]

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.[6]

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.[7] And still others -- perhaps some of the greatest -- are imposed by those who would be retained by companies to assist them in raising capital.[8]

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[5] 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.

[6] 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.

[7] 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.

[8] *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 the 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 familar 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,[9] SEC Chairman,[10] and SEC Commissioners of both major political parties[11] 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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[9] *See generally*, Treasury Capital Markets Report.

[10] 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.

[11] *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.[12]

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.[13]

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.[14] 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.[15]

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

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[12] See, e.g., Joshua T. White, SEC, *Outcomes of Investing in OTC Stock*, Dec. 16, 2016, a*vailable at* 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.").

[13] *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.

[14] 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.

[15] See, e.g., California Public Employees' Retirement System, *Total Fund Investment Policy*, at 7, (effecitve 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.[16] 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."

[16] 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/.

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),[17] 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.[18] 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 occured in 2008, and only 41 occured in 2009.[19]

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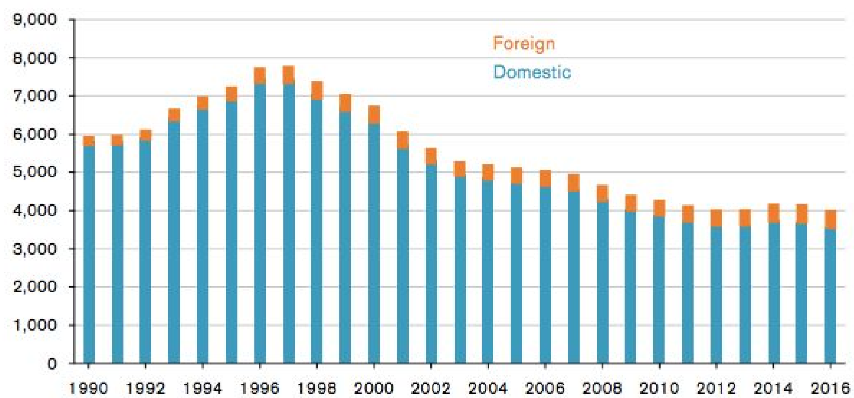
[17] Jay R. Ritter, *Initial Public Offerings: Updated Statistics*, (Jan. 17, 2018), *available at* https://site.warrington.ufl.edu/ritter/files/2018/01/IPOs2017Statistics_January17_2018.pdf.

[18] Ritter.

[19] 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.[20]

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.[21]

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.[22]

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[20] 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.

[21] Treasury Capital Markets Report, at 21.

[22] 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.[23]

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.[24]

[23] *Securities Offering Reform*, SEC, 70 Fed. Reg. at 44726 (Aug. 3, 2005), *available at* https://www.sec.gov/rules/final/33-8591fr.pdf.
[24] 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."[25]

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[26] 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

[25] 70 Fed. Reg. at 44727.
[26] 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.[27]

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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[27] *Notice of Filing of Amendment No. 1 and Order Granting Approval of a Proposed Rule Change, as Modified by Amendment No. 1, to Introduce Cboe 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.[28] 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.

[28] *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.[29] 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.[30]

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.[31] Similarly, if the research and execution costs are

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[29] 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.
[30] 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.
[31] 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.[32]

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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[32] 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; 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_%2022%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.[33]

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.[34] 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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[33] See, e.g., Weild, et. al.

[34] 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. 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.