Written Testimony of Brett Paschke

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on behalf of

the Securities Industry and Financial Markets Association

before the U.S. House of Representatives

Committee on Financial Services

Subcommittee on Capital Markets, Securities, and Investment

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

May 23, 2018

Chairman Huizenga, Ranking Member Maloney, and distinguished members of the Subcommittee, thank you for the opportunity to testify today on the importance of preserving the vibrancy of our public capital markets. My name is Brett Paschke and I am the Head of Equity Capital Markets at William Blair, testifying today on behalf of the Securities Industry and Financial Markets Association (SIFMA)[1]. William Blair is a premier global boutique, headquartered in Chicago, with expertise in investment banking, investment management, and private wealth management. On behalf of individuals, families, private and public pension funds, endowments and foundations, we manage approximately $100 billion in client investments. On the capital markets side of our business, for which I am responsible, we are best known for serving the needs of small and mid-cap growth companies, including many innovative leaders in technology, health care and life sciences. Over the last ten years, we have been an underwriter on approximately 20 per cent of all US-listed IPOs. We provide sell side research for over 600 public companies, we are an active market maker in over 3,600 stocks, and our institutional sales force covers many of the world's leading growth stock investors. I will do my best to bring these perspectives and experiences to the Subcommittee today.

I joined William Blair directly out of Harvard Business School 21 years ago because I wanted to help business founders raise capital to build companies, invent products, solve problems, cure diseases, create jobs and provide wealth creation opportunities for the investing public. All these years, and many deals later, I am still motivated and inspired by the opportunity to help our clients achieve their missions. I served on the IPO Task Force in 2011 that put together the recommendations that

[1] SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $18.5 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org."

became the JOBS Act and am very pleased to be here today to continue that work. SIFMA welcomes the attention that this Committee, the Administration, the Securities and Exchange Commission (SEC) and other policymakers have paid to the important issue of preserving the vibrancy of our public capital markets.

It is difficult to overstate the change that has occurred in U.S. public capital markets over the last twenty years. An explosion in private funding, the rise of index and passive investing, technological advances in our equities markets such as electronic trading (which improved liquidity, ease of trading, availability of information about issuers, and the ability of retail investors to participate in public markets), the development of hedge funds, high frequency trading, the maturation of international exchanges, consolidation in the investment banking industry, and yes, the impact of regulations from Sarbanes-Oxley and Dodd-Frank have all played a role in reshaping our markets. Unfortunately, not all the changes have been positive. From a peak in 1996, the total number of publicly listed companies in the U.S. has fallen by almost 50%, from 8,000+ to just over 4,000. The U.S. now has about as many public companies as it did in the early 1980s. The annual number of US-listed IPOs dropped from a peak of almost 750 in 1996 to between 28 and 255 annually for the period from 2001 to today, despite the attempts of policymakers to revitalize this market through the Jumpstart Our Business Startups (JOBS) Act of 2012 and follow-on legislation. I spend much of my time meeting with private company executives, their Boards and their investors, discussing alternatives for raising capital and realizing value. More often than not these decisionmakers cite the costs of going and staying public, the demands of quarterly reporting, regulatory and corporate governance requirements, and the reduced number of success stories as reasons that they prefer to be funded privately or to sell their business to a strategic acquirer or private equity fund. The explosion of private capital markets, led by angel investors, venture capital firms and private equity firms has allowed companies to grow their business and valuations without ever tapping public markets.

It is worth discussing why this evolution matters. One important implication is that many startup companies are being built to be sold, as opposed to being built to be independent public companies. This often does not lead to the same level of expansion and job growth that a long life as an independent public company does. Another important implication is that access to the private markets is limited to a much smaller group of high net worth individuals and institutions, effectively excluding retail investors from the value creation that occurs with these companies. Our public markets provide much greater access to wealth creation, from direct retail investing to the mutual funds that manage money on behalf of individuals, retirement plans, pension funds, and endowments. Our public capital markets also remain critical for issuers and investors with their provisioning of deep liquidity that private markets simply cannot replicate. The liquidity in the market for public securities allows investors to quickly enter and exit even large positions, making equities an attractive asset class for investors everywhere. Public capital markets yield more accurate valuations of corporate securities as investors have access to financial information from across markets, and the accompanying public disclosure distributes important information on market trends. While private markets are important in their own way and are undoubtedly popular with entrepreneurs, they are unable to match the broad access, liquidity, and other benefits of public markets. Even as they encourage innovation, policymakers should be concerned about the current trend of companies shunning public markets and so again SIFMA commends the focus on these topics.

Indeed, the need to support our public capital markets is why SIFMA, the U.S. Chamber of Commerce, and a broad coalition of stakeholders joined together recently to produce a report entitled "Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public."[2] The signatory organizations for that report believe that the recommendations contained within could increase the attractiveness of public markets for issuers. SIFMA believes the report balances the need to streamline issuer obligations with a recognition that investor confidence is a critical component to the vibrancy of public capital markets. We also support many of the draft bills that have been released alongside this hearing. Some of these proposals – such as updating shareholder resubmission thresholds and allowing underwriters to communicate with prospective investors on behalf of well-known seasoned issuers (WKSIs) – are examples of thoughtful updates to our securities laws that will help those laws keep pace with the intense changes our public markets have undergone.

With that in mind, I would like to discuss several specific recommendations within the coalition report that SIFMA believes could have a significant positive impact on public markets. Let me make an important caveat -- we do not believe that any single policy change will reverse the decline in publicly listed companies or unlock the IPO market. The authors of the JOBS Act understood this and wisely took a holistic approach to improving capital formation. Policymakers today should take on our present challenges with a similar mindset.

Lengthen the EGC On-Ramp

Congress began addressing the issue of the deteriorating IPO markets in the JOBS Act of 2012, which created a new category of issuer, the Emerging Growth Company (EGC), and created an "on-ramp" of scaled corporate disclosure requirements for those issuers through their first five

[2] https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/04/IPO-Report_EXPANDING-THE-ON-RAMP.pdf

years as a public company. As stated earlier, SIFMA believes the high costs today of being a public company relative to the costs of being a private company have shifted the issuer incentives away from public markets. The JOBS Act's on-ramp of tailored financial reporting requirements and auditing and accounting standards greatly eased the burden for smaller companies going public and virtually all the post-JOBS Act IPOs have been EGCs. Unfortunately, many smaller companies time-out of EGC status before reaching the gross revenue limitation of $1 billion. Even five years after going public an issuer may not be a fully mature company, especially if it is still developing its core intellectual property, such as a pharmaceutical or technology product. Congress has an opportunity to build on the JOBS Act's successes by extending the on-ramp provisions for issuers from five to ten years while maintaining the current revenue threshold. SIFMA is glad to see that draft legislation achieving this change was released by the Committee in conjunction with this hearing. Providing a longer runway for companies to scale up to the full public reporting requirements should incentivize more issuers to go and stay public.

Testing the Waters

Another important provision of the JOBS Act was the ability to file draft registrations statements confidentially, which allows companies interested in an IPO to manage the timing and release of their proprietary and financial information. The benefits of confidential filing, however, are multiplied when coupled with the JOBS Act's "testing the waters" provision that allowed EGCs to gauge investor interest in securities prior to an offering. These provisions are especially popular with those whose businesses rely on complex intellectual property (especially in the technology and biotechnology sectors) and who benefit from additional opportunities to explain their business and outlook to investors. The SEC has already expanded the confidential filing flexibility to all issuers but has not expanded "testing the waters" to all issuers. While much effort has been targeted on improving the environment for smaller prospective issuers, policymakers should also find ways to attract companies of all sizes to the public market, including those that have grown to maturity in private markets. These companies would also greatly benefit from the flexibility to gauge interest among a wider array of investors and reduce uncertainty before formally launching an IPO. In that regard, "testing the waters" benefits both investors and issuers and is an excellent example of a JOBS Act reform that should be expanded from EGCs to all issuers.

Research Rule 139

The provisioning of research on publicly traded companies is one of the most critical, but least understood, facets of our public capital markets. Research coverage of companies can improve liquidity in thinly-traded stocks by increasing investor interest and awareness. The importance of research for healthy capital markets should remain a key focus in capital formation discussions as this coverage is vital for investors throughout all stages of a company's life, and diminished research coverage of small cap companies should raise serious concerns. SEC Rule 139 provides a safe harbor for research produced by broker-dealers participating in a distribution if the issuer is a large reporting company under the '34 Act. This safe harbor ensures that research is not considered an offer of securities, with the accompanying liability. At present, Rule 139's safe harbor only shelters research reports on large reporting companies or S-3 eligible issuers. This arbitrary limitation means that coverage of smaller issuers must cease during an offering of their securities, a time when research would be quite valuable to investors. Impeding the provisioning of research does not protect investors in these cases and the disparate treatment unnecessarily disadvantages smaller companies. We recommend that policymakers expand the Rule 139 safe harbor to research of all issuers.

Eliminate "Baby-Shelf" Restrictions

Shelf registration is a commonly-used method of accessing capital markets, as it allows issuers to pre-register securities offerings in advance of sale, with the actual offering occurring when the issuer needs or wants capital. The flexibility of shelf registrations, filed using Forms S-3 and F-3, can lead to significantly lower costs for issuers. Unfortunately, many small-cap issuers (including EGCs) are subject to "baby-shelf" rules that limit the amount of capital they can raise through shelf registrations. Today, baby-shelf rules limit companies with less than $75 million in public float to selling securities worth no more than 1/3rd of their public float. This limitation makes it very difficult for small-cap companies to timely and opportunistically raise the capital needed for expansion or research & development. EGCs that need to raise more than is allowed under the "baby-shelf" rules may be forced to undergo either a private placement (which typically forces securities to be offered at a discount due to their diminished liquidity) or a confidential S-1 filing (which entails a far more complex registration process). Allowing all issuers, including EGCs and small-cap issuers, to take advantage of shelf registration without a limit on the amount they can raise will make public markets far more attractive to small-cap issuers. This change will also create new opportunities for retail investors to invest in early-stage companies and possibly to realize higher returns. Eliminating the baby-shelf cap strikes a sound balance between assisting issuers and protecting investors, as the SEC still requires detailed disclosures from would-be issuers about the type of securities offered and the use of the proceeds.

Diversified Fund Limits

Any attempt to revitalize our public markets must reckon with the extraordinary growth that has taken place in the registered mutual fund industry over the last 20 years. Mutual funds – the buy side of our equity markets – have become an increasingly important way that households and investors access our capital markets. Since 1990, the number of total registered mutual funds has grown about ten times, mean fund size has more than doubled, and open-end fund holdings of US corporate equities has reached approximately 24% of the entire market. This growth means the investment decisions of mutual funds today are an important aspect of our public capital markets. However, large mutual funds' investing preferences have shifted away from IPOs, and especially small IPOs. Several factors explain this change, but one that policymakers have rightfully paid attention to is the diversified fund limits that govern mutual fund investments. The current 10% limit on mutual fund positions limits interest in small-cap IPOs because as large funds' assets under management (AUM) grows, the 10% limit means that any investment in a small IPO will have a negligible impact on overall fund return. Asset managers seeking returns are increasingly passing on small IPOs to focus on larger ones and demanding greater returns from small IPOs to justify an investment at all. Declining mutual fund interest in small IPOs also materially weakens the trading environment for small-cap stocks and likely deters small firms from joining our public markets. SIFMA believes that the proposed legislation, providing for a modest increase in the diversified fund limit threshold from 10% to 15% of voting shares, will increase buy-side interest in small IPOs and improve liquidity in small-cap stocks. However, we urge Congress also address the tax implications of such a change, because the tax code currently limits Regulated Investment Company (RIC) status to funds that meet the 10% threshold and raising the diversified fund limit cap without addressing the tax implications will effectively leave the status quo in place.

Conclusion

Policymakers certainly have a challenge before them -- improving the vibrancy of our public markets while balancing investor protections. But the U.S. capital markets are the envy of the world and worth the effort to preserve. SIFMA and its members stand ready to assist the Committee and the SEC in this important endeavor. Thank you for this opportunity to testify today, I look forward to your questions.

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