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Examining Investor Risks in Capital Raising

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Chairman Reed, Ranking Member Crapo, my name is Kate Mitchell and I am a managing director at Scale Venture Partners, a Silicon Valley-based venture capital firm that has investments in information technology companies across the United States. Venture capitalists are committed to funding America's most innovative entrepreneurs. We work closely with them to transform breakthrough ideas into emerging growth companies that drive U.S. job creation and economic growth. We believe that IPOs drive job creation and economic growth because, as our data show, 92 percent of a company's job growth occurs after its IPO.

I am also a former chairman and current member of the National Venture Capital Association. Companies that were founded with venture capital accounted for 12 million private sector jobs and $3.1 trillion in revenue in the U.S. in 2010, according to a 2011 study by IHS Global Insight. That equals approximately 22 percent of the nation's GDP. Almost all of these companies, which include Apple, Cisco, Genentech and Starbucks, began small but remained on a disciplined growth trajectory and ultimately went public on a U.S. stock exchange.

More recently, I served as chairman of the IPO Task Force, a private and independent group of professionals representing the entire ecosystem of emerging growth companies — including experienced CEOs, public investors, venture capitalists, securities lawyers, academicians and investment bankers. This diverse coalition came together initially as part of a working group conversation at the U.S. Department of the Treasury's Access to Capital Conference in March 2011, where the dearth of initial public offerings, or IPOs, was discussed at length. In response to this shared concern, we formed the IPO Task Force to examine the challenges facing America's troubled market for IPOs and make recommendations for restoring effective access to the public markets for emerging growth companies.

Our task force developed our proposals based on a consensus approach that considered, and in many cases rejected, a variety of possible approaches. We left behind many ideas based on the valuable input we received from the variety of interdisciplinary perspectives that our membership represented. We released our report, "Rebuilding the IPO On-Ramp," in October of this year. We shared our findings and recommendations with Members of Congress and the Administration, including the Treasury Department and the Securities and Exchange Commission (SEC). I have submitted a copy of this report along with my written testimony today.

On behalf of the diverse members of the IPO Task Force, I am here today to support S. 1933, the "Reopening American Capital Markets to Emerging Growth Companies Act of 2011." This bipartisan legislation, introduced by Senators Schumer, Toomey, Warner, and Subcommittee Ranking Member Crapo, will help restore effective access to the public markets for emerging growth companies without compromising investor protection. Restoring that access will spur U.S. job creation and economic growth at a time when we desperately need both. I appreciate the opportunity to discuss with you the challenges we face and the merits of this important bill.

Challenges Facing the U.S. IPO Market

For the last half-century, America's most promising young companies have pursued IPOs to access the additional capital they need to hire new employees, develop their products and expand their businesses nationally and globally. Often the most significant step in a company's development, IPOs have enabled emerging growth companies to generate new jobs for the U.S. economy, while public investors of all types have harnessed that growth to build their portfolios and retirement accounts.

The decision to pursue an IPO is a complex one because alternatives *do* exist: a company can seek to be acquired or can decide to remain private. The most prevalent outcome today for the CEO of an emerging growth company is to be acquired by a larger company. Yet the IPO remains appealing, although demonstrably less so than it was a decade ago, for a variety of reasons. In a survey the IPO Task Force conducted of more than 100 CEOs of companies considering an IPO in the next 24 months, 84 percent of CEOs cited competitive advantage as the primary motivation for going public, while two thirds of them indicated the need for cash to support future growth. And while 94 percent of CEOs agreed that a strong and accessible small-cap IPO market is critical to maintaining U.S. competitiveness, only 9 percent agreed that the market is currently accessible to them.

The data support that unfortunate conclusion. During the past 15 years, the number of emerging growth companies entering the capital markets through IPOs has plummeted relative to historical norms. From 1990 to 1996, 1,272 U.S. venture-backed companies went public on U.S.

exchanges, yet from 2004 to 2010, there were just 324 of those offerings. Those companies that do make it to the public markets are taking almost twice as long to do so. During the most recent decade, acquisitions have become the predominant path forward for most venture-backed companies. This is significant because M&A events do not produce the same job growth as IPOs. In fact, an acquisition often results in job losses in the short term as redundant positions are eliminated by the acquirer. While global trends and macroeconomic circumstances have certainly contributed to this prevalence of acquisitions over IPOs, the trend has transcended economic cycles and has hobbled U.S. job creation.

What is driving this precipitous decline in America's IPO market? A number of analyses, including that of the IPO Task Force, suggest that there is no single event behind it. Rather, a complex series of changes in the regulatory environment and related market practices have driven up costs and uncertainty for emerging growth companies looking to go public, and have constrained the amount of information available to investors about such companies, making them more difficult to understand and invest in. These changes have included the advent of electronic trading, new order-routing rules, Regulation FD, the Gramm-Leach-Bliley Act of 1999, decimalization, the Sarbanes Oxley Act of 2002, the Global Research Analyst Settlement, and aspects of the Dodd-Frank Act of 2009. Every one of these developments and each piece of legislation addressed significant issues. Yet, the cumulative effects of these regulations over the years have produced an unintended consequence: They have limited the ability of emerging growth companies to go public.

In effect, these changes have shifted the focus of emerging growth companies away from pursuing IPOs and toward positioning themselves for acquisition by a larger company. In fact, approximately 85 percent of the emerging growth company CEOs surveyed by the IPO Task Force indicated that going public is not as attractive as it was in 1995. This shift toward acquisitions and away from IPOs by emerging growth companies is problematic for the U.S. economy because, as mentioned, acquisitions simply do not generate the same amount of job growth as IPOs. Consider the impact on jobs and the general economy if companies such as FedEx, Intel or Microsoft were acquired by larger corporations instead of going public and maintaining the independent growth that led them to be market leaders in their own right.

Addressing these multiple, interrelated factors and mitigating their effects will require a measured and nuanced response. Many of the new regulations in recent years have addressed specific concerns and delivered valuable protections to investors — protections that any efforts to rebalance the regulatory scales for emerging companies must recognize and respect. These new requirements have raised the bar for companies pursuing IPOs — in terms of size, compliance and cost — in ways that should inspire greater investor confidence in our markets. Similarly, many of the related market evolutions have increased access and lowered costs for some public investors. These factors have resulted in a fundamental restructuring of the U.S. capital markets system over the past 15 years. Our IPO Task Force report examines this restructuring and its implications in greater depth. For my purposes here, I will focus on the regulatory aspects of the current IPO challenge and how S. 1933 can mitigate it.

I believe the "Reopening American Capital Markets to Emerging Growth Companies Act of 2011" provides an opportunity to thoughtfully recalibrate these regulations to reduce barriers for ECG's in three crucial ways. First, it recognizes emerging growth companies as a unique category facing acute challenges in accessing public capital. Second, it provides a limited, temporary and scaled regulatory compliance pathway, which the IPO Task Force referred to as an "on-ramp," that will reduce the costs and uncertainties of accessing public capital. Third, it improves the flow of information to investors about the initial offerings for emerging growth companies. The legislation follows a balanced approach by structuring the on-ramp as a temporary feature available only for a limited period of one to five years, depending on the size of the company.

Recognizing "Emerging Growth Company" Challenges

The "Reopening American Capital Markets to Emerging Growth Companies Act of 2011" would establish a new category of issuer, called an "emerging growth company" (EGC) that has less than $1 billion in annual revenues at the time of SEC registration. These companies would benefit from a temporary regulatory on-ramp designed to provide EGCs with a smooth entryway into the IPO market while ensuring adequate investor protection. This on-ramp status would last only for a limited period of one to five years, depending on the company's size, and it would encourage EGCs to go public while ensuring that they achieve full compliance as they mature and build the resources necessary to sustain the level of compliance infrastructure associated with larger enterprises.

As noted, EGC status, and the scaled regulation associated with the on-ramp, would last for a limited period of one to five years. Specifically, EGC status would cease at the first fiscal year-end after the company (1) reaches $1 billion in annual revenue; (2) has been public for five years; or (3) becomes a "large accelerated filer" with more than $700 million in public float (i.e., market value of shares held by non-affiliates). To put the bill's limited scope in perspective, if the on-ramp provisions were in effect today, they would apply to only 14 percent of public companies and only 3 percent of total market capitalization, according to the IPO Task Force estimate. For example, Ford Motor Company would not qualify as an EGC eligible for the on-ramp. Nor would Zynga be expected to qualify. However, Carbonite and Horizon Pharmaceuticals would.

As someone who has spent the last 15 years seeking out, evaluating, investing in, and helping to build promising young companies, I cannot overemphasize the value of a robust and accessible IPO market. In our survey of emerging growth company CEOs, 86 percent of respondents listed accounting and compliance costs as a major concern of going public. Again, over 85 per cent of CEOs said that going public was not as attractive of an option as it was in 1995. Given these concerns, for CEOs of successful companies deciding between pursuing an IPO or positioning themselves for an acquisition, the scaled disclosure and cost flexibility provided by the bill could help make an IPO the more attractive option.

Reopening Access through Scaled Regulation

The bill provides qualifying EGCs with a narrow, temporary and scaled regulatory compliance pathway that would reduce the costs of accessing public capital without compromising investor protection. The bill's transitional relief is limited to those areas of compliance that are significant cost drivers. While those requirements may sensibly apply to larger enterprises, allowing EGCs to phase in these costs would not compromise investor protection for smaller public companies that are following the scaled regulation that the SEC has already developed and approved for smaller reporting companies. In this way, the on-ramp benefits from the SEC's prior regulatory actions that carefully balanced both investor protection and the promotion of efficiency, competition, and capital formation, consistent with Section 3(f) of the Securities Exchange Act of 1934. The scaled regulations under the bill include:

Section 404(b) of Sarbanes-Oxley. In addition to the typical cost of auditing their financial statements, large public companies must pay an outside auditor to attest to the company's internal control over financial reporting. Studies have shown that compliance with Sarbanes-Oxley can cost companies more than $2 million per year, with much of that cost associated with the Section 404(b) requirements. All companies with a public float of less than $75 million are already exempt from Section 404(b) because Congress has recognized the substantial burden this requirement would impose on smaller companies. In addition, existing regulations provide that all newly public companies — regardless of their size or maturity — benefit from a transition period of up to two years before they are required to comply with Section 404(b) of Sarbanes-Oxley. Under current law, this transitional relief is available even for very large companies that would not qualify as EGCs. Moreover, this existing transitional relief is necessary even though the auditing standard for the Section 404(b) audit is intended to be flexible and scalable. (The Public Company Accounting Oversight Board's Auditing Standard No. 5 expressly permits a top-down, scalable approach for the audit and recognizes that "a smaller, less complex company" may "achieve its control objectives differently than a more complex company.") Building on these concepts, S. 1933 provides EGCs with a limited and targeted extension of the existing transition period during the on-ramp for compliance with Section 404(b). The bill would not affect current requirements under which management is responsible for establishing and maintaining internal control over financial reporting and disclosure controls and procedures.

Look-back for audited financials. EGCs would be required to provide audited financial statements for the two years prior to registration, rather than three years. This two-year period already applies under existing SEC rules for companies with a public float of less than $75 million. For the year following its IPO, the EGC will go forward reporting three years of audited financials, similar to larger issuers, without facing an incremental cost burden because the third year will have already been audited in connection with the IPO. The transition period for this element, therefore, will only extend for a year, which is much shorter than the full on-ramp period.

Exemptions from long form compensation disclosure. The EGC will disclose its compensation arrangements using the established format that the SEC has adopted for smaller reporting companies. The bill would also exempt EGCs from the requirement to hold an advisory stockholder vote on executive compensation arrangements, including advisory votes on change-of-control compensation arrangements and the frequency of future advisory votes. The SEC has given smaller reporting companies an additional year to comply with the new rules, in light of the additional burden these requirements impose. The bill would extend this transitional relief for EGCs during the on-ramp period. During that time, EGCs would still be required to comply with all stock exchange governance requirements, including director independence requirements.

The on-ramp period will give EGCs the opportunity to realize the benefits of going public in their first, critical years in the public markets. They will be able to allocate more of the capital they raise from the IPO process toward hiring new employees, developing new products, expanding into new markets and implementing other elements of their growth strategies — as opposed to funding the type of complex compliance apparatus designed for larger, more mature companies. At the same time, EGCs and their management will be able to devote more time, energy and other resources to managing the business, charting the path to future growth and implementing compliance systems that are appropriate for smaller, more nimble companies. Indeed, 92 percent of the public-company respondents in the IPO Task Force's CEO survey identified the burden of administrative reporting as a significant challenge, while 91 percent noted that reallocating their time from company building to compliance management has been a major challenge.

The IPO Task Force's membership included institutional investors who provided important perspectives that shaped the specific recommendations we made. In particular, the scaled regulation that we ultimately recommended, and which S. 1933 reflects, incorporated key recommendations from the investor community that this constituency believes is consistent with investor protection and will ensure full disclosure of all relevant information by EGCs as well as the availability and flow of information for investors.

Improving the Availability and Flow of Information for Investors

Along with compliance burdens, post-IPO liquidity ranked very high among the concerns of emerging growth company CEOs. Institutional investors in particular expressed concerns about the dearth of information and exposure they had to IPO companies versus what they receive for other securities, making it difficult to get enough information to make an informed investing decision about a new issue. In order to increase post-IPO liquidity, investors need efficient markets with abundant, accurate information about newly public companies. In an effort to make IPOs more attractive to EGCs and investors, the bill would improve the flow of information about EGCs to investors before and after an IPO. It will do so primarily by updating existing regulations to account for advances in modes of communication since the enactment, 78 years ago, of the Securities Act of 1933, and to recognize changes in the information available to investors in the Internet era. Current rules relating to analyst research were initially adopted more than 40 years ago — long before the fundamental changes that the Internet has brought regarding the availability of information, including instantaneous access to registration statements filed with the SEC. The SEC has amended these rules only modestly and incrementally since that time. Specifically, the bill will:

Close the information gap for emerging growth companies. Existing rules allow investment banks participating in the underwriting process to publish research on large companies on a continuous basis, but prohibit those investment banks from publishing research on EGCs. This bill would allow investors to have access to research reports about EGCs concurrently with their IPOs. In other words, S. 1933 extends to EGC investors the research coverage currently enjoyed by investors in very large companies. At the same time, the bill preserves the extensive investor protections adopted in this area within recent years. For example, S. 1933 leaves intact robust protections such as:

- Sarbanes-Oxley Section 501, which requires analysts and broker-dealers that publish research reports to disclose any potential conflicts of interest that may arise when they recommend an issuer's equity securities, including whether an analyst or broker-dealer currently owns other debt or equity investments in the issuer or has received compensation from the issuer for publishing the report or whether the issuer is a client of the broker-dealer.
- SEC Regulation AC, which requires broker-dealers to include in all research reports a statement by the research analyst certifying that the views expressed in the research report accurately reflect the research analyst's personal views about the securities and to disclose whether the research analyst was compensated in connection with the specific recommendations.
- The Global Research Analyst Settlement of 2003, which severed the link between research and investment banking activities at large investment banks, required investment banks to use independent research and made analysts' historical ratings and price targets publicly available.

As the SEC recognized in 2005, the "value of research reports in continuing to provide the market and investors with information about reporting issuers cannot be disputed." We agree that research reports are indisputably valuable to investors and endorse the changes in S. 1933 that would permit research coverage of EGCs at the time of an IPO, rather than the current regime, which permits research only for large, established public companies. The bill's changes would address the current information shortfall by providing a way for investors to obtain research about IPO candidates, while leaving unchanged the robust and extensive investor protections that exist to ensure the integrity of analyst research reports.

Permit emerging growth companies to "test the waters" prior to filing a registration statement. The bill would permit EGCs to gauge preliminary interest in a potential offering by expanding the range of permissible pre-filing communications to institutional and qualified investors. This would provide a critically important mechanism for EGCs to determine the likelihood of a successful IPO. For a company on the verge of going public, but not quite ready, getting that investor feedback beforehand improves the chances of a successful IPO at a later date. This benefits issuers and the public markets in the process by helping otherwise-promising companies avoid a premature offering. All of the antifraud provisions of the securities laws would still apply to these communications, and the bill ensures that the delivery of a statutory prospectus would still be required prior to any sale of securities in the IPO.

Permit confidential pre-filing with the SEC. Currently, foreign entities are permitted to submit registration statements to the SEC on a confidential basis under certain circumstances, even though U.S. companies are not. Since the recent introduction of S. 1933, the SEC staff has updated its policy in this area to permit confidential filings for foreign governments registering debt securities and foreign private issuers that are listed or are concurrently listing on a non-U.S. securities exchange. This accommodation is not available to domestic issuers. Allowing U.S. companies to make confidential submissions of draft registration statements would allow EGCs to commence the SEC review process in a far more efficient and effective manner. In particular, this process would remove a significant inhibitor to IPO filings by allowing pre-IPO companies to begin the SEC review process without publicly revealing to competitors sensitive commercial and financial information before those pre-IPO companies are able to make an informed decision about the feasibility of an IPO. The bill would require U.S. companies that elect to use the confidential submission process to make public the filing of the initial confidential submission as well as all amendments resulting from the SEC review process, thereby providing full access to the information before an IPO that is traditionally disclosed to the public during the registration process. The bill would also require such a public filing at least 21 days before the pre-IPO company commences a road show with potential investors, providing ample time for public review of all changes made in all amendments to the registration statement occurring during the SEC review process.

Conclusion

With the U.S. economic recovery stalled, unemployment hovering near 9 percent and global competition ramping up, the time to revive the U.S. IPO market and jumpstart job creation is now. We believe that the "Reopening American Capital Markets to Emerging Growth Companies Act of 2011" can help us accomplish those goals without compromising important investor protections, including many of the reforms implemented in recent years.

The bill provides measured and limited relief, for a period of one to five years, to a small population of strategically important companies with disproportionately positive effects on job growth and innovation. We believe that these changes could provide powerful incentives for those emerging companies to more seriously consider an IPO as a feasible alternative when they are deciding between the growth potential of an IPO versus the safer and easier path of an acquisition transaction. As a result, we believe these changes could bring those alternatives back to their historical balance — a balance that has, in prior years, allowed IPOs to occur more easily and, in so doing, supported America's global economic primacy for decades.

I urge the members of this committee to support the passage of the "Reopening American Capital Markets to Emerging Growth Companies Act of 2011." By doing so, we can re-energize U.S. job creation and economic growth by helping reconnect emerging companies with public capital — all while enabling the broadest range of investors to participate in the growth of those companies through a healthy and globally respected U.S. capital markets system. These outcomes are not only consistent with the spirit and intent of the current regulatory regime, but also essential to preserving America's strength for decades to come.

In closing, I want to personally thank you for the opportunity to discuss these important issues with you today. I look forward to answering any questions you may have and, I thank you for your service to our country in your capacity as Members of Congress and your attention to this critical issue.