Legislative Proposals to Increase Access to Capital

Testimony by
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Committee on Banking, Housing, and Urban Affairs
U.S. Senate

The Honorable Mike Crapo, Chairman
The Honorable Sherrod Brown, Ranking Member

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Protecting Small Business, Promoting Entrepreneurship

Chairman Crapo and members of the committee, thank you for hosting this important hearing today on the issue of access to capital. The Small Business & Entrepreneurship Council (SBE Council) is pleased to submit this testimony.

My name is Raymond Keating and I serve as chief economist for the Small Business & Entrepreneurship Council (SBE Council), a nonprofit, nonpartisan advocacy, research and education organization dedicated to protecting small business and promoting entrepreneurship. For nearly 25 years, SBE Council has worked on a range of private sector and public policy initiatives to strengthen the ecosystem for healthy startup activity and small business growth.

Small Business and Access to Financial Capital

Throughout SBE Council's history, access to capital has been a core issue. Of course, financial capital – whether equity or debt – stands out as a foundational matter for entrepreneurs who are starting up, operating or expanding businesses. However, for many entrepreneurs, gaining access to capital has long been a challenge.

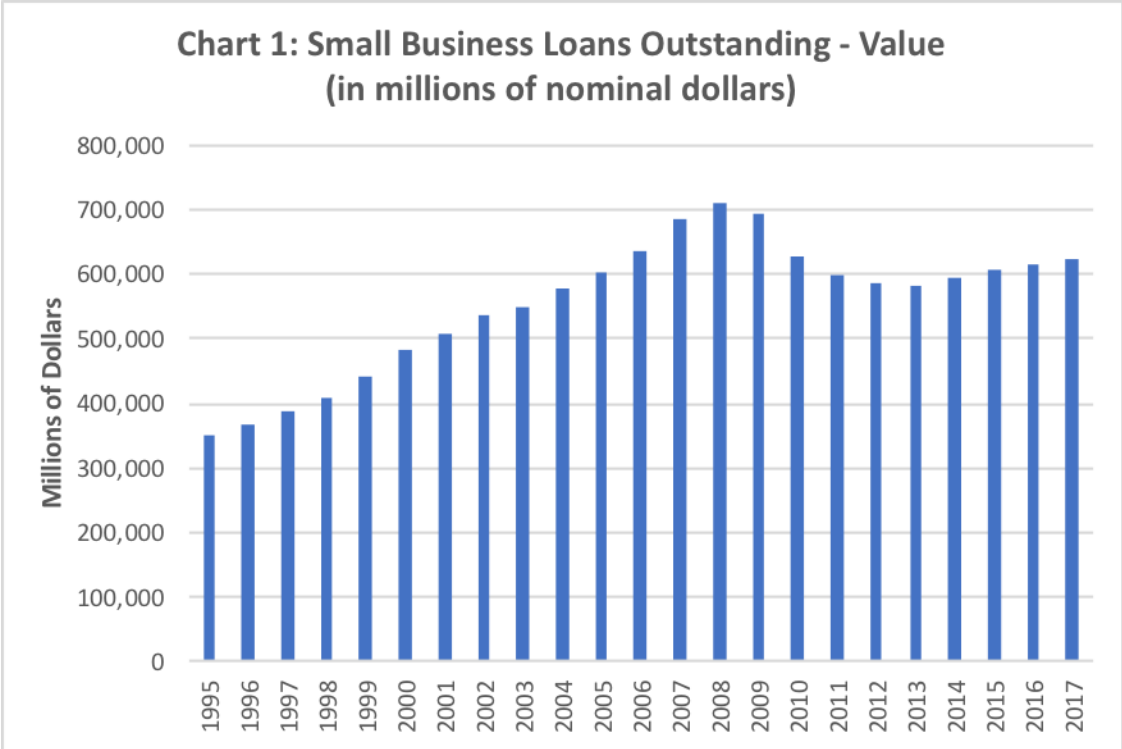
During the financial crisis, the Great Recession and an under-performing recovery, capital became increasingly hard to access from institutional banks and various capital market players. And while matters have improved in recent years, many entrepreneurs continue to struggle with accessing the capital they need to compete and grow.

Small Business Loans. Consider the trends in bank small business loans (less than $1 million) over the past decade or so, as displayed in Charts 1 and 2.

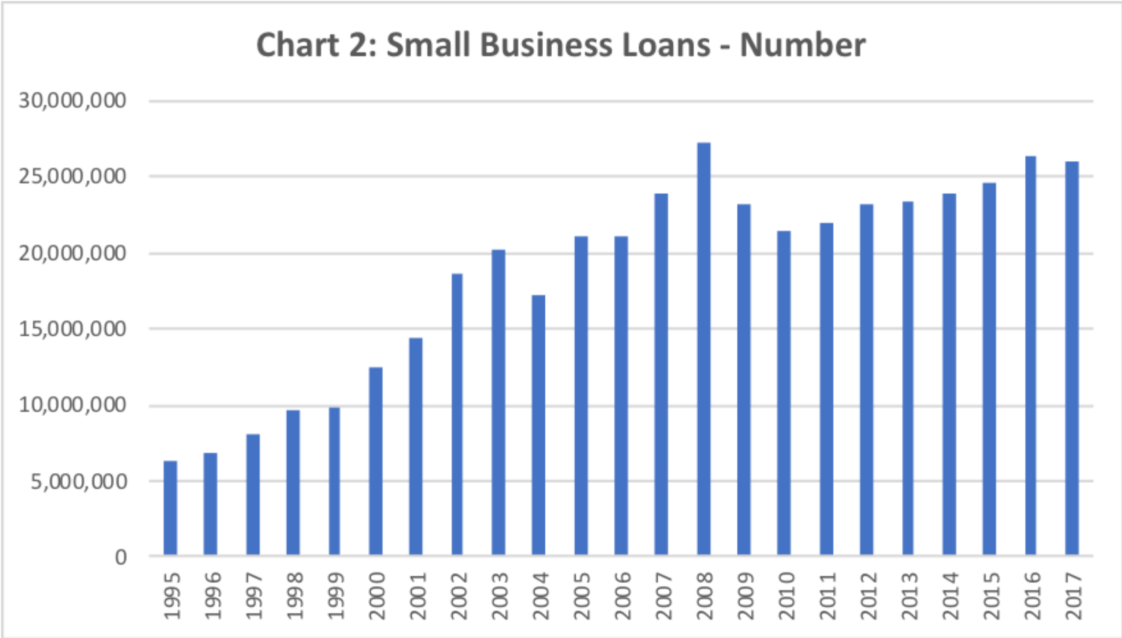
Chart 1 shows that the value of small business loans outstanding hit a high of $711.5 billion in 2008, and subsequently fell for five straight years. Growth resumed in 2014, and has continued since. But recovery to the 2008 high is yet to occur, never mind factoring in any additional growth. In fact, the 2017 level of $623.1 billion came in at less than the 2006 level. So, small business loan value has experienced no growth for more than a decade, and consider that these numbers are nominal, so inflation is not even factored in, which would make the picture bleaker.

The small business share of commercial and industrial loan value outstanding registered, for example, 33 percent in 1995, 35 percent in 2004, 30 percent in 2007, and in early 2010, it registered 31 percent. However, the subsequent decline has been rather stark, falling to 20 percent by mid-2015 and remaining at that level since. Looking at nonfarm nonresidential loans, the small business share came in at 52 percent in 1995, and had declined to 39 percent in 2007. And at the end of 2017, the small business share further declined to 20 percent.

As for the number of small business loans, these rose steadily up to 2008 (hitting 27.1 million in 2008 compared to 6.3 million in 1995), and subsequently declined into early 2011 (coming in at 21.3 million) and then working to recover, climbing back to 26.4 million in mid-2017.However, there was a falloff in the second half of 2017, retreating to just below 26 million. Again, the level at the end of 2017 remained below the 2008 level.



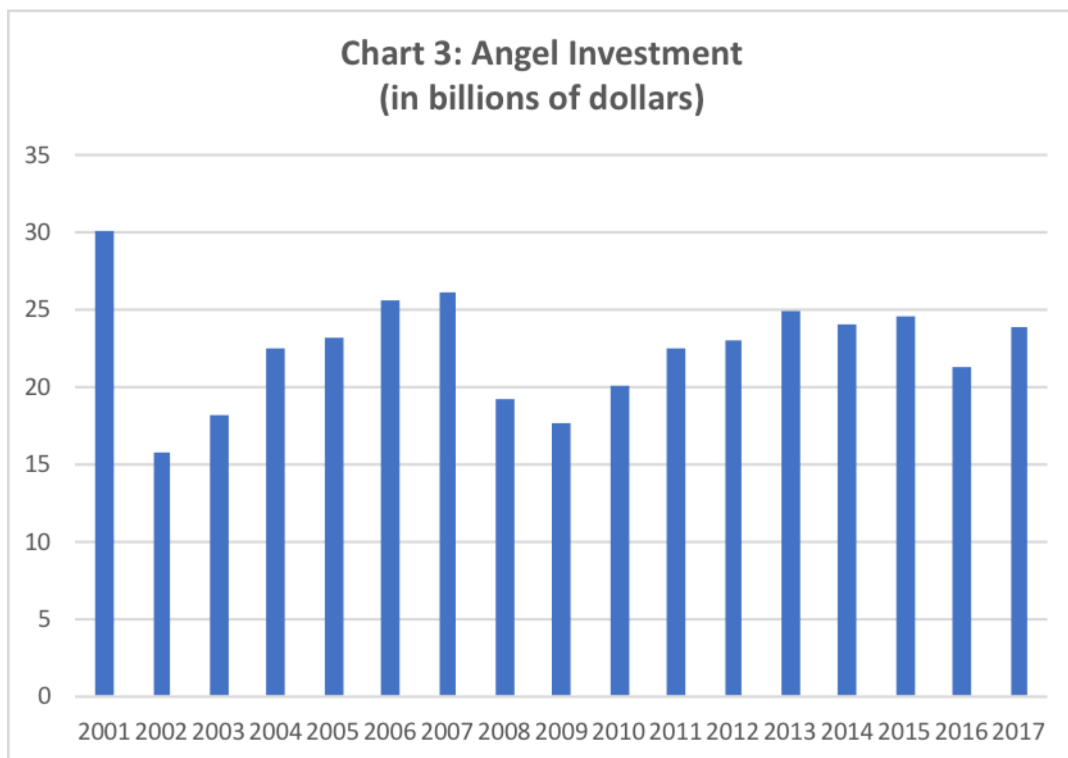
Data Source: Federal Deposit Insurance Corporation, Quarterly Banking Profile



Data Source: Federal Deposit Insurance Corporation, Quarterly Banking Profile

Angel Investment. On the equity side, angel investment stands out as a critical source of funding for start-ups and early-stage businesses. But here, the numbers have been disappointing in recent years.

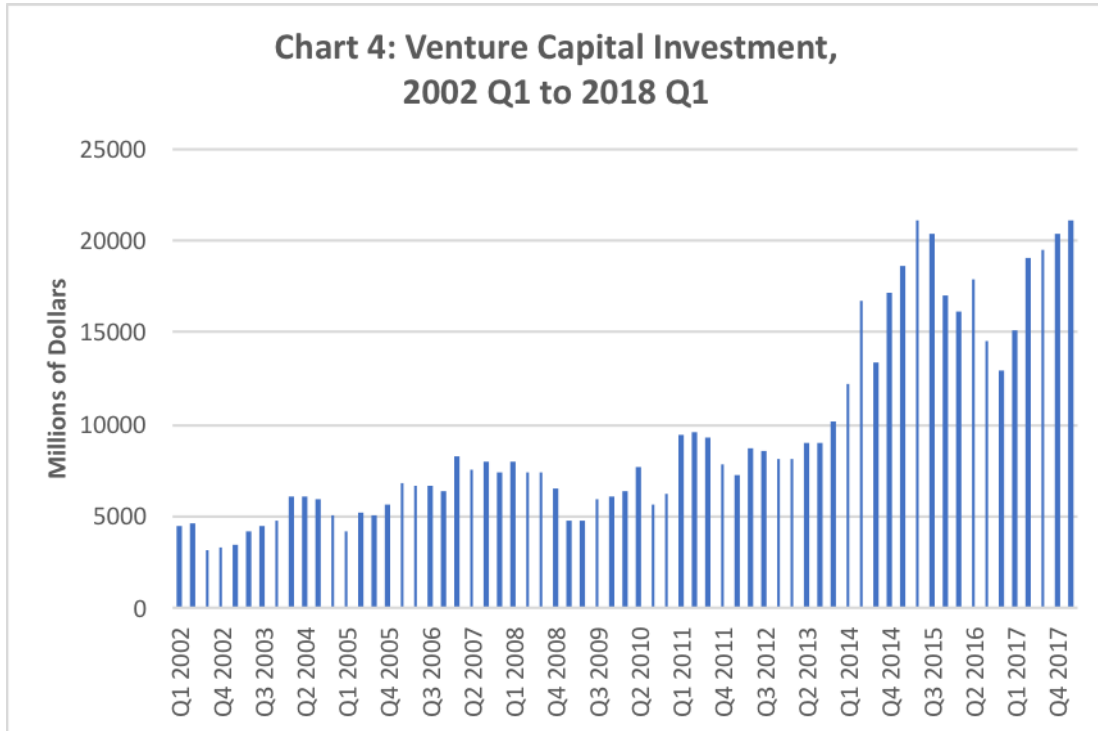
According to numbers from the Center for Venture Research at the University of New Hampshire (as seen in Chart 3), moving past a big drop in angel investment in 2002, coinciding with the aftermath of the 2001 recession (as well as the post "tech bubble"), growth resumed from 2003 through 2007, with angel investments increasing from $15.7 billion in 2002 to $26 billion in 2007. Subsequently, though, there was a large decline in 2008 and 2009 during the recession. Post-recession growth was underwhelming, growing from $17.6 billion in 2009 to $24.8 billion in 2013. Since then, however, angel investment has stagnated – in fact, actually declining some, coming in at $23.9 billion in 2017.



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

As for the number of deals (again, according to the Center for Venture Research at the University of New Hampshire), they grew from 36,000 in 2002 to 57,120 in 2007. After a brief falloff in 2008, growth then resumed, eventually rising to 73,400 in 2014. So, while total angel investment dollars declined and then recovered some from 2007 to 2014, the number of deals grew robustly, pointing to angel investors being active in more deals at lower investment levels. Unfortunately, over the last two years – during 2016 and 2017 – angel investment dollars declined slightly, and over the last three years – 2015, 2016 and 2017 – the number of deals dropped notably, from 73,400 in 2014 to 61,560 in 2017. The 2017 deal level of 61,560 came in at about the same level as in 2010 (61,900 deals).

Venture Capital. While not an option for most start-ups or very young firms, venture capital investment is an important avenue for innovative firms to raise capital for growth and expansion. The trend on the venture capital front after the Great Recession tends to show more robust growth, even with a decline from the second quarter of 2015 to the fourth quarter of 2016. Since then venture capital investment has bounced back nicely, and over the longer run, growth has been solid since the end of the recession – moving from $4.8 billion in the second quarter of 2009 to $21.2 billion in the first quarter of 2018.



Data Source: PwC/CBInsights MoneyTree™ data explorer, http://www.pwc.com/moneytree

Online Lending and Crowdfunding. Finally, the growth of online lending and crowdfunding for entrepreneurs must be highlighted. SBE Council President & CEO Karen Kerrigan noted the following in her recent testimony (June 21, 2018) before the U.S. House of Representative's Committee on Financial Services:

> There's been improvement in the online lending space as some of the nation's largest "FinTech" small business lending platforms are quietly helping many entrepreneurs with their capital needs. A May 31, 2018 study, "The Economic Benefits of Online Lending to Small Businesses and the U.S. Economy" reported that just five of the largest lending platforms funded nearly $10 billion in online loans from 2015 to 2017, generating $37.7 billion in gross output, creating

> 358,911 jobs and $12.6 billion in wages in U.S. communities. The study found that 24 percent of these borrowers are microbusinesses with less than $100,000 in annual sales and two-thirds have less than $500,000 in annual sales. So online lenders are definitely filling an important niche, and small business borrowers are becoming better educated about this type of financing.
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> The Jumpstart Our Businesses Startup Act (JOBS Act) included solid reforms that have helped boost Initial Public Offerings (IPOs) and deliver many startups the funding they need through regulated crowdfunding (Title III crowdfunding). It took the Securities and Exchange Commission (SEC) four long years to develop and implement the rules around regulated crowdfunding, which is why it has taken longer than expected to get traction through this promising funding approach. Regulation crowdfunding is quietly funding companies and doing what its supporters, like us, hoped it would. To date, there are nearly 1,000 active campaigns (about 600 of those are fully funded), where $132 million has been committed from 133,883 backers (investors). The average raise is $247,456. A wide array of sectors are represented, with application software companies leading the pack followed by beverages (alcoholic), computer hardware, entertainment and the auto industry.

To sum up, long after the financial crisis hit in late 2008 and the Great Recession came to an official end in mid-2009, the financial capital story for the small business community has been mixed. While having recovered some, small business loans are still well off from where they should be. Angel investment has largely stagnated. Meanwhile, venture capital has shown solid growth, while online lending and crowdfunding have opened new doors for many entrepreneurs seeking funding.

Regulatory Burdens

Regarding the trends noted above, assorted factors have come into play, including the under-performing economy over a period of a decade and a decline in entrepreneurial activity. Challenges among small community banks also come into play given the important role these institutions play in lending to small businesses. And community banking woes also tie back to the state of the economy, but to government regulation as well, which, again, always falls heaviest on small businesses, including small banks.

In a May 2016 analysis, I noted the following:

> Consider key points from two recent reports on the state of community banks. A study published in February 2015 by the Harvard Kennedy School's Mossavar-Rahmani Center for Business and Government, titled The State and Fate of Community Banking and authored by Marshall Lux and Robert Greene, looked at the role of community banking in the marketplace, as well as the impact of Dodd-Frank financial regulation law on these small banks.

The authors note that "community banks provide 51 percent of small business loans," and quote William Grant, then chairman of the Community Bankers Council of the American Bankers Association, pointing out, "The cost of regulatory compliance as a share of operating expenses is two-and-a-half times greater for small banks than for large banks."

As for the Dodd-Frank impact, the authors note, "Community banks (defined as banks with less than $10 billion in assets) withstood the financial crisis of 2008-09 with sizeable but not major losses in market share – shedding 6 percent of their share of U.S. banking assets between the second quarter of 2006 and mid-2010… But since the second quarter of 2010, around the time of the Dodd- Frank Wall Street Reform and Consumer Protection Act's passage, we found community banks' share of assets has shrunk drastically – over 12 percent." They go on to observe: "Interestingly, community banks' vitality has been challenged more in the years after Dodd-Frank than in the years during the crisis."

And at another point, they state: "[C]ommunity bank consolidation trends have almost doubled since the passage of Dodd-Frank, relative to the Q2 2006 and Q2 2010 time frame, which includes the crisis period." The authors added: "As the GAO reports, regulators, industry participants, and Fed studies all find that consolidation is likely driven by regulatory economies of scale – larger banks are better suited to handle heightened regulatory burdens than are smaller banks, causing the average costs of community banks to be higher."

As noted in a March 2015 report from the Federal Reserve Bank of Richmond, the sizeable decline in the number of community banks from 2007 to 2013 – shrinking by 41 percent – was not only about community bank failures, but about "an unprecedented collapse in new bank entry."

It is noted: "This collapse in new bank entry has no precedent during the past 50 years, and it could have significant economic repercussions. In particular, the decline in new bank entry disproportionately decreases the number of community banks because most new banks start small. Since small banks have a comparative advantage in lending to small businesses, their declining number could affect the allocation of credit to different sectors in the economy."

Potential issues include the state of the economy and Federal Reserve policymaking: "An important factor in bank profitability is the net interest margin, or the spread between deposit rates and lending rates. The Fed's policy of keeping the federal funds rate near zero since 2008 has pushed lending rates down, which has kept the net interest margin relatively small. Adams and Gramlich [of the Federal Reserve Board of Governors] estimate that this low interest rate environment coupled with weak demand for banking services accounts for as much as 80 percent of the decline in bank entry in recent years. However, a literal interpretation of their model would predict that even if the net interest margin and economic conditions recovered to 2006 levels, there still

> would be almost no new bank entry, suggesting that other factors are also important for explaining the recent decline."
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> The authors write: "Banking scholars also have found that new entries are more likely when there are fewer regulatory restrictions. After the financial crisis, the number of new banking regulations increased with the passage of legislation such as the Dodd-Frank Act. Such regulations may be particularly burdensome for small banks that are just getting started."
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> The Richmond Fed report concludes: "If *de novos* [i.e., newly formed banks] are absent due to the low interest rate environment and weak economic recovery, then entry should increase as the economy improves and the Fed raises interest rates. If regulatory costs are the driving force behind low entry rates, then future entry will depend on how those costs change over time."

Writing in the American Banker in October 2017, Camden R. Fine, then-president and CEO of the Independent Community Bankers of America, echoed some of these points. He explained:

> Community banks are highly capitalized, so they're better prepared than their larger competitors for economic crises. And as local institutions, they reinvest in their communities and channel loans to their depositors' neighborhoods—promoting localized growth that radiates out to the broader economy. Community banks have been instrumental in helping the nation recover from the financial crisis and economic downturn, yet their numbers continue to dwindle, declining by roughly 1,500 since 2009. As the only physical banking presence in nearly one in five of the nation's 3,000 counties, this lifeline to many American families is at risk.
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> The mere trickle of de novo banks entering the market exacerbates the problem. The number of bank applications has plummeted from more than 100 per year before the crisis to just a handful since 2009—posing tangible risks to financial services access and economic growth in communities overlooked by larger institutions.
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> Regulatory burden plays no small part in the growing consolidation. A new survey from the Federal Reserve and Conference of State Bank Supervisors found that community bank compliance costs have increased by nearly $1 billion in the past two years to roughly $5.4 billion, or 24% of community bank net income. Of the respondents who said they considered an acquisition offer in the past year, virtually all (96.7%) said regulatory costs were a very important, important or moderately important reason. Further, the Federal Reserve Bank of Richmond has found that regulatory costs play a key role in the recent dearth of applications to form new community banks.

Efforts to Expand Access to Financial Capital

Reform and relief efforts to clear away obstacles and reduce costs for lenders, investors, entrepreneurs and small businesses on the financial capital front are most welcome. For example, SBE Council supports the following bills being discussed today:

S. 588 Helping Angels Lead Our Startups Act or the HALOS Act – This bill clarifies that startups and entrepreneurs can showcase their ideas and businesses at events designed to connect them with potential investors. It clarifies the rules about “demo days” and similar events hosted by universities, government, accelerators and other entities that help entrepreneurs network, make connections, and identify funding for their enterprises. As noted in the joint statement released by the Senate bill’s sponsors: “In order for startups to secure capital and grow their businesses, entrepreneurs often attend ‘demo days.’ or conferences to showcase their business model in front of investors like ‘angel investors’ and venture capitalists. It is estimated that angel investors provide 90 percent of outside equity to help grow these young businesses. Unfortunately, recent regulations now require excessive hurdles for angel investors, deterring them from participating in demo days. The *HALOS Act* would preserve important investor vetting processes without forcing startups to jump through unnecessary hoops to get the investments they need to grow and create new jobs.” U.S. Senator Chris Murphy (D-Conn.) stated, “I’m reintroducing the *HALOS Act* because the most important thing we can do to help local entrepreneurs is knock down road blocks and make it easier for angel investors to put capital behind them.”

S. 2126 Fostering Innovation Act of 2017 - Sensibly extends an exemption allowed for in the JOBS Act to growing companies whose business models require more regulatory flexibility, and thus will enable greater success. Extends the JOBS Act’s SOX 404(b) exemption for an additional five years for former emerging growth companies (EGCs) that maintain a public float below $700 million and average annual revenues below $50 million. As Senator Gary Peters (D-MI) has observed, “This bipartisan, commonsense legislation would cut red tape for emerging bio-technology companies so they can focus their resources on the critical research and development that will provide innovative treatments and save lives.”

S. 2347 Encouraging Public Offerings Act of 2018 – As U.S. Chris Van Hollen (D-MD) has pointed out, “Many emerging businesses find that the process of going public is too complex and expensive.” Given that reality, this bill would streamline the process by allowing an issuer communicate with potential investors to “test the waters” in terms of gauging interest in a contemplated securities offering, either before or after the filing of a registration statement, and allowing an issuer to submit a confidential draft registration statement to the Securities and Exchange Commission for review prior to public filing or within one year after the initial public offering or registration. U.S. Senator Thom Tillis (R-NC) correctly observed, “IPOs give companies crucial access to our capital markets, and yield the potential to create thousands of jobs. When private companies consider going public, we should be doing everything possible to make this process easy and to encourage it, without jeopardizing investor protections.”

S. 3004 Small Business Audit Correction Act of 2018 - As is clear from the data and a wide array of studies, regulatory burdens fall heaviest and with greatest consequence on small

businesses. This legislation would redress the Dodd-Frank requirement that all investment brokers and dealers, no matter their size, must hire a Public Company Accounting Oversight Board (PCAOB)-registered audit firm to conduct audits that use complex guidelines designed for larger, public companies. As noted in the statement from Senators Tom Cotton (R-Arkansas) and Doug Jones (D-Alabama), "This requirement is devastating for small investment firms... These firms are closing at an alarming rate, in part due to skyrocketing audit costs required by a rule that is illogical for firms that don't hold customer assets. The Small Business Audit Correction Act would exempt privately-held, small non-custodial brokers and dealers in good standing from the requirement to hire a Public Company Accounting Oversight Board (PCAOB)-registered audit firm to meet their annual SEA Rule 17a-5 reporting obligation and would instead reinstate the previous regulatory audit requirements."

S. 2765 RBIC Advisers Relief Act of 2018 – This bill would reduce unnecessary costs by amending the Investment Advisers Act of 1940 to exempt investment advisers who solely advise certain rural business investment companies.

In addition to these pieces of legislation, several other measures would expand access to capital for entrepreneurs and small businesses. In SBE Council's "2018 Policy Agenda for Entrepreneurs and Small Businesses – Issue Two: Access to Capital," assorted additional pro-small-business measures were highlighted, including:

H.R. 477 Small Business Mergers, Acquisitions, Sales and Brokerage Simplification Act of 2017 – H.R. 477 reduces regulatory costs associated with the sale and purchase of small, privately held companies. Current law forces broker dealers to register with the Security and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), and one or more states at substantial costs. This results in higher transaction costs for many entrepreneurs who want or need to sell their business.

H.R. 2201 Micro Offering Safe Harbor Act – H.R. 2201 would exempt from registration requirements with the Securities and Exchange Commission (SEC) offerings made only to the entrepreneur's friends and family, to less than 35 purchasers, and when $500,000 or less is raised. The offering would be exempt from state registration and qualification rules, thus reducing costs and complexity. H.R. 2201 would appropriately scale SEC rules and regulatory compliance for our nation's small businesses, which in turn will provide another practical option for entrepreneurs to raise the capital they need to start or grow their firms.

H.R. 78 SEC Regulatory Accountability Act – H.R. 78 requires the SEC to assess the costs and benefits of regulatory actions and the impacts on small businesses, investor choice, and market liquidity. The bill also requires an exploration of regulatory alternatives, including the option of not regulating, to maximize the net benefits of SEC rulemakings. Having SEC periodically review its regulations is critically important as cumulative and outdated regulation put U.S. capital markets at a competitive disadvantage.

Other Bipartisan Proposals on the Move – There is movement in the U.S. House on several bipartisan bills that are also strongly supported by SBE Council. For example, the "Main Street Growth Act," H.R. 5877, would allow for the creation of venture exchanges, which would

provide a tailored trading platform for small issuers and emerging growth companies (EGCs). The "Modernizing Disclosures for Investors Act," H.R. 5970, requires the SEC to provide a report to Congress with a cost-benefit analysis of EGCs' use of SEC Form 10-Q and recommendations for decreasing costs, increasing transparency, and increasing efficiency of quarterly financial reporting by emerging growth companies. Both of these bills advanced out of the Financial Services Committee unanimously. Another bill also recently reported out of the committee, the "Helping Startups Continue to Grow Act," H.R. 6130, would provide for a five year extension of certain Security Exchange Act exemptions and reduced disclosure requirements for companies designated as EGCs and will continue to remain as such but for the five-year restriction on EGCs. Under Title I of the JOBS Act, the IPO "on-ramp" for EGCs provides exemptions and provisions that make sense given the size and development of these small firms. The scaling of rules and exemptions from certain disclosure requirements for EGCs have reduced compliance and regulatory burdens, which have benefited these promising small firms. Each of these bills work to modernize and streamline rules, or make important fixes, which will make the capital markets work better for small businesses and improve U.S. capital formation.

Mobilizing More Capital to Startups and Small Businesses – As noted in my testimony, regulated (Title III) crowdfunding is beginning to gain traction in the marketplace. Refining some of rules would help many entrepreneurs tap into this promising funding option. Some of the reforms supported by SBE Council include raising the amount that can be raised (which is currently $1 million), allowing issuers to "test the waters," allowing for special (or single) purpose vehicles, providing simplified rules for advertising, legal clarity for platforms, and removing the caps for accredited investors, among other changes.

Congress is updating thresholds across many areas of the law, and the same needs to be done with Section 1224 Small Business Stock, which allows investors to deduct losses taken on investments in C Corp startups. Qualified Small Business tax (loss) treatment under Section 1244 of the I.R.S. code (QSB 1244) was passed as part of the Small Business Investment Company Act of 1958, the spirit of which was to mobilize more capital into innovate startups. The current thresholds were last updated in 1978, which are: the first $1,000,000 of outside, individual tax payer(s) (angel investors) capital receives 1244 treatment; $100,000 per year of 1244 losses deductible against ordinary income (for joint tax returns); $50,000 per year of 1244 losses deductible against ordinary income (for single filers). The Consumer Price Index has risen 363% since 1978. If the above thresholds were inflation adjusted, the levels would be: $3,630,000 of outside investors' capital would qualify for de-risking under 1244; $363,000 per year of 1244 losses could be deductible for joint filers: $181,500 per year for single filers. These changes would be consistent with the laudable changes recently made to the QSB 1202 laws, which now provide for the first $10M of profits that qualify under 1202 to be excluded from taxes.

This change can help up-and-coming entrepreneurial ecosystems outside Silicon Valley as well as Opportunity Zones where many new investors and family offices are interested in impact investing.

Capital Gains Tax Relief. Finally, it must be noted that capital gains tax relief is needed to boost access to capital for the entrepreneurial sector of our economy, and further enhance

economic, income and employment growth. One key measure would be reducing the capital gains tax rate – such as from the current rate on individuals of 23.8 percent to 10 percent or 15 percent – while also indexing gains for inflation so that the real capital gains tax rate does not climb higher than the stated nominal rate. In the end, the capital gains tax raises diminishes the returns on and disincentivizes investment and entrepreneurship. Reduce the capital gains tax substantially, and that would be good news for the risk taking that drives the economy forward.

Thank you for your time and attention. I look forward to your questions and further discussion.

About Raymond J. Keating

Raymond J. Keating is chief economist for the Small Business & Entrepreneurship Council. Keating is the author of several books, including *Unleashing Small Business Through IP: Protecting Intellectual Property, Driving Entrepreneurship*, *"Chuck" vs. the Business World: Business Tips on TV*, and a series of thrillers. For more than two decades, he was a weekly newspaper columnist with *Long Island Business News*, *Newsday*, and the *New York City Tribune*. For a decade, Keating also was an adjunct professor in the MBA program at the Townsend School of Business at Dowling College. His work has appeared in a wide range of additional periodicals, including *The New York Times, The Wall Street Journal, The Washington Post, New York Post, Los Angeles Daily News, The Boston Globe, National Review, The Washington Times, Investor's Business Daily, New York Daily News, Detroit Free Press, Chicago Tribune, Providence Journal Bulletin,* and *Cincinnati Enquirer*.

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