September 9, 2019

The Honorable Maxine Waters  
Chairwoman  
Committee on Financial Services  
U.S. House of Representatives  
Washington, D.C. 20515

The Honorable Patrick McHenry  
Ranking Member  
Committee on Financial Services  
U.S. House of Representatives  
Washington, D.C. 20515

The Honorable Carolyn B. Maloney  
Chair  
Subcommittee on Investor Protection,  
Entrepreneurship, and Capital Markets  
U.S. House of Representatives  
Washington, D.C. 20515

The Honorable Bill Huizenga  
Ranking Member  
Subcommittee on Investor Protection,  
Entrepreneurship, and Capital Markets  
U.S. House of Representatives  
Washington, D.C. 20515

Dear Members of the Committee:

We are very pleased to see that a hearing has been scheduled for this week in the Investor Protection, Entrepreneurship, and Capital Markets Subcommittee on the critically important topic of “Examining Private Market Exemptions as a Barrier to IPOs and Retail Investment.” This hearing comes at a time when mounting evidence suggests that four decades of policies to promote private securities offerings have placed our nation’s public securities markets at risk. Instead of addressing that problem, the Securities and Exchange Commission (SEC) has issued a Concept Release that, in the name of “harmonizing” private offering exemptions, threatens to make the problem worse.¹

We therefore urge Congress to take the preliminary step of placing a moratorium on any further expansion of private offering exemptions until additional study can be conducted to determine the likely impact on investor protection, market transparency, efficiency and integrity, and the overall health of the nation’s public markets. This hearing is an excellent start. Instead of supporting further expansion of private exemptions, we believe a fair analysis will show that certain existing exemptions should be significantly narrowed, or even eliminated, in order to restore an appropriate balance between public and private markets.

• **U.S. public markets are in decline.**

Whether you measure by number of initial public offerings (IPOs), number of companies listed on a national exchange, or percentage of U.S. companies that choose to go public, the downward trend is inescapable. For example:

• The number of public companies today is approximately 23 percent lower than it was in 1977. It has dropped more than 50 percent from the peak of just over 8,000 in 1996 to roughly 3,600 at the end of 2017.²

• And, as both the overall number of U.S. companies and the U.S. population have grown, both the ratio of listed firms to all U.S. firms and the number of U.S. listed firms per capita have also plunged dramatically.

• While a significant portion of the decline has come from delistings, particularly in the years following the bursting of the tech stock bubble,³ the number of IPOs is also down sharply.

• One analysis found that there was an average of just 99 IPOs per year from 2001 through 2012, compared with an average of 310 IPOs per year between 1980 and 2000.⁴ While IPO rates have risen since the financial crisis, they remain well below earlier averages from the 1980s and 1990s.

The decline is particularly marked among smaller companies. For example, despite the dramatic decline in the overall number of IPOs, the amount of total proceeds from IPOs has continued to climb. As Ernst & Young stated in its analysis of market statistics, “companies conducting a US IPO today are raising more money than ever before.”⁵ This reflects the fact that companies typically wait much longer than they once did before conducting an IPO, often delaying going public until after they have achieved significant growth through private investments. Meanwhile, as of early 2017, the average market capitalization of a U.S.-listed public company was $7.3 billion, compared to an average of $1.8 billion in 1996. And approximately 140 companies with more than $50 billion in market capitalization constituted more than half of the total U.S. market capitalization.⁶ As Professor Elisabeth de Fontenay put it in her study on The Deregulation of Private Capital and the Decline of the Public Company, if these trends continue, “the typical U.S. public company will be a corporate behemoth that is no longer growing meaningfully,” and our public markets, “no longer the promised land for

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² Editorial Board, Where Have All the Public Companies Gone? Bloomberg Opinion (April 9, 2018), available at: https://bloom.bg/2RwuEBE.


⁵ E&Y, Looking Behind the Numbers.

⁶ E&Y, Looking Behind the Numbers.
companies poised to grow” will be little more than “a holding pen for massive, sleepy corporations.”

- **Private offering exemptions are the primary cause of public markets’ decline.**

While some seek to blame this decline on the increasing costs associated with being a public company, an examination of the evidence clearly shows that the primary responsibility for our public markets’ decline can be traced to the dramatic expansion of private offering exemptions beginning in the early 1980s. Indeed, the disruption of public markets can be largely attributed to four significant rule changes:

- adoption of Regulation D in 1982, which eliminated the need for companies to conduct a public offering in order to raise large amounts of capital;
- adoption of Rule 144A in 1989, which made it easier to sell private securities to large institutional investors and thus further reduced the need for companies to turn to the public markets for financing;
- loosening of Rule 144 trading limits on restricted securities, which reduced the need for companies to go public to enable founders, early investors, and employees to liquidate their shares; and
- raising of the ceiling under Section 12(g) of the Securities Exchange Act of 1934 on the number of shareholders a company can have without having to become a publicly reporting company, which eliminated the need for even very large companies to begin filing periodic reports and thus reduced their incentive to go public.

In short, as Professor de Fontenay argues persuasively in her paper, policies that enabled and encouraged private capital raising seriously undermined the benefits companies derived from going public. As a result, “even if public company disclosure requirements had remained constant over the last three decades, there would likely still be a dearth of public companies today, due to the increasing ease of raising capital privately.”

Moreover, while these regulatory changes were adopted in the name of promoting small company access to capital, the data tells a very different story. For example, while operating companies are the most frequent users of Reg D, only $105 billion (just under six percent) of the $1.8 trillion raised in reliance on Regulation D in 2017 was raised by operating firms. The largest users of the exemption, at $582 billion raised, were private equity funds, whose role in

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7 De Fontenay, “The Deregulation of Private Capital.”
9 Scott Bauguess, Rachita Gullapalli, and Vladimir Ivanov, Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017, Division of Economic and Risk Analysis (DERA) U.S. Securities and Exchange Commission (August 1, 2018), available at: https://www.sec.gov/files/DERA%20white%20paper_Regulation%20D_082018.pdf. The $105 billion was raised by “issuers in non-financial industries,” which the authors define as all issuers that are not pooled investment funds and that are not in commercial banking, insurance, investing, investment banking, and other banking and financial services. According to the authors, the group is primarily comprised of operating firms.
10 Id.
job creation is mixed at best.\textsuperscript{11} Rule 144A has been used to enable often complex, opaque, and risky securities to be sold to large financial institutions, a practice that poses significant potential risks for our financial system. For example, many of the mortgage-backed securities at the heart of the 2008 financial crisis were sold as Rule 144A offerings. More recently, similar concerns have arisen over the sale of leveraged loans through Rule 144A offerings.\textsuperscript{12} Meanwhile, a major effect of the Section 12(g) changes was to enable huge companies with widely dispersed shareholders to remain private long after they have grown large enough to afford shouldering the responsibilities of being a public company. This is epitomized by the explosive increase in recent years in the number of “unicorns” – companies that grow to at least $1 billion in valuation while remaining private. There are now an estimated 496 such companies, including 21 companies valued at $10 billion more.\textsuperscript{13} That’s up from just 40 unicorns in 2013.\textsuperscript{14}

- **Investors are harmed by the migration of capital raising from public to private markets.**

Some might ask why policymakers should care if capital raising is shifting from public to private markets, as long as issuers of all sizes have access to capital on affordable terms. That certainly appears to be the assumption behind the SEC’s Concept Release on harmonization of offering exemptions. But investors enjoy very real benefits when securities trade in public, rather than private markets. These start, of course, with the far greater transparency that exists in public markets and the attendant benefits that transparency brings. They include more reliable valuations, greater liquidity, lower trading costs, and better regulatory oversight. Investors got an important reminder just last week of how important disclosure is to accurate valuations. In a development reminiscent of the Uber IPO earlier this year, reports emerged that WeWork may go public at less than half the valuation it secured from its biggest backer just a few months ago.\textsuperscript{15} Meanwhile, Uber’s stock has continued its steady decline since its May IPO, and it is now valued at less than half the $120 billion valuation it achieved in the private markets before it was required to begin providing the robust disclosures demanded in public markets.\textsuperscript{16}

\textsuperscript{11} See, e.g., Steven J. Davis, John Haltiwanger, Kyle Handley, Ben Lipsius, Josh Lerner, and Javier Miranda, The Social Impact of Private Equity Over the Economic Cycle (January 1, 2019) (Using a sample that covers thousands of buyouts from 1980 to 2013, the study finds that, “Employment at target firms shrinks by nearly 13% relative to controls over two years in buyouts of publicly listed firms but expands by 11% in buyouts of privately held firms.”); also, Michael Frerichs and Joe Torsella, “Congress must act on measure putting tighter regulation on private equity firms,” The Hill (Aug. 11, 2019); Lydia DePillis, “Rich investors may have let a hospital go bankrupt. Now, they could profit from the land,” CNN Business (July 29, 2019);


\textsuperscript{13} CrunchBase Unicorn Leaderboards, TechCrunch, https://techcrunch.com/unicorn-leaderboard/.

\textsuperscript{14} Jones, Renee M. (2017) “The Unicorn Governance Trap,” University of Pennsylvania Law Review Online: Vol. 166 : Iss. 1 , Article 9, available at: https://scholarship.law.upenn.edu/penn_law_review_online/vol166/iss1/9

\textsuperscript{15} See, e.g., Michelle Davis, Giles Turner, and Gillian Tan, “WeWork Targets $20 Billion to $30 Billion IPO Value,” Bloomberg (Sept. 5, 2019), available at: https://bloom.bg/2k32XUV.

As the SEC explains, the disclosure obligations in the ’33 Act and ’34 Act are based on “a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it. Only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions.”17 For decades, companies’ ability to rely on the private offering exemption turned on whether offerees had access to the same type of information they would receive if the company were registered. But Reg D abandoned that approach, with the result that hundreds of billions of dollars in private securities are now sold each year without providing the basic facts necessary for an informed decision. That poses significant risks, not just for the individual investors who risk making poor investment decisions, but also for the broader economy, which suffers when capital fails to flow to its best uses. As the SEC has noted, a side effect of the transparency provided by ’33 Act and ’34 Act disclosures “is a far more active, efficient, and transparent capital market that facilitates the capital formation so important to our nation’s economy.”18 That is put at risk when capital raising shifts from public to private markets.

But the benefits of public markets for investors don’t end with transparency. Public markets are fundamentally egalitarian in a way that private markets are not. This is particularly important for retail investors, including individual accredited investors, who operate at a distinct disadvantage in private markets. No matter how small the investment, retail investors who trade on a public exchange are assured of getting the best currently available price. They receive timely updates regarding important developments through the periodic disclosures required under the ’34 Act. They are protected against selective disclosure of material information by Regulation Fair Disclosure. And they generally have the same ownership rights as large institutional investors when they purchase stock in public companies. None of those protections apply in the private markets, where large investors can, and often do, receive more favorable treatment. Among other things, large investors are more likely than individuals to be able to protect themselves against the threat of dilution in future funding rounds.

These risks are exacerbated by the fact that private companies operate with less scrutiny from regulators and gatekeepers than public companies, and without the same control mechanisms to discipline their conduct. Among the important differences is the lower liability standard that applies to private offerings. As Professor Renee Jones writes in her paper on The Unicorn Governance Trap, “Because Unicorns are free from public disclosure requirements, they can engage in questionable activities with less fear of exposure, and do not face the same threat of securities fraud claims that helps discipline managers of public companies.”19 She adds that, “in the absence of an impending IPO, Unicorn managers and investors lack sufficient incentives to develop governance structures and practices appropriate for enterprises of their scale.”20 While Jones’ analysis is focused on unicorns, because of the significant influence they have on our economy, the same lack of accountability holds true for other private companies as well.

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18 Id.
19 Jones, The Unicorn Governance Trap at 179.
20 Id. at 167-168.
Those whose answer to the decline in public markets is to advocate expanded retail investor access to private markets miss this basic point. The effect of such policies would be to move retail investors out of markets where they operate on a relatively level playing field into one where the field is steeply tilted against them.

- We support legislation to require further study of private markets and their impact on public markets.

Private markets today dwarf our public markets in terms of the number of offerings and amount of capital raised. This makes it all the more troubling that the SEC doesn’t currently collect even the most basic data about broad swaths of the private markets. For example, the SEC cannot say with any degree of certainty who currently invests in private offerings made under Regulation D, the largest of the private offering exemptions. Nor can it do more than provide a rough estimate of how much money is raised through such offerings. And it has no data whatsoever on how successful Reg D offerings by operating companies are either in terms of investor outcomes or in terms of promoting sustainable job creation and economic growth. Where it does have somewhat more data, for example in the Reg A and crowdfunding markets, the available data is hardly encouraging.

- We, therefore, strongly support the Private Securities Transparency and Reform Act discussion draft. By strengthening the filing requirements for Regulation D offerings, the bill would help to ensure that the SEC collects the data necessary to understand this market and support informed policy-making.

- While Regulation D is of paramount importance, because of the size of this market, the same concerns about lack of data to support informed policy-making apply more broadly. We, therefore, also strongly support the SEC Study for Rulemakings to Expand or Create Registration Exemptions discussion draft. Recognizing that private offering exemptions have a critical impact on public markets and that the SEC’s current Concept Release fails to consider those impacts, the legislation would help to ensure that the SEC conducts an appropriate analysis before proceeding with further rulemaking to expand private offering exemptions along the lines of those put forward in the Concept Release.

- We urge the Committee to delay consideration of further exemptions that could expand private markets until after that study has been completed.

Until the analysis required by these draft bills can be conducted, we strongly oppose the adoption of additional legislation that could have the effect of further expanding private markets at the expense of public markets.

- For example, while we agree that reforms to the accredited investor definition are badly needed, we urge the Committee to hold off on adopting any such changes (including those in the Fair Investment Opportunities for Professional Experts Act) until the data can

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21 See Concept Release at 21. (“There are many possible reasons why the amount of capital raised in exempt offerings exceeds the amount raised in registered offerings. However, the focus of this concept release is to seek input on whether, in light of the increased activity in the exempt markets, the current exempt offering framework is working effectively to provide access to capital for a variety of issuers, particularly smaller issuers, and access to investment opportunities for a variety of investors while maintaining investor protections.”)
be collected that would enable us to better understand who invests in Regulation D offerings, how that may differ for investments in pooled investments versus operating companies, and how their investments fare. We believe that a careful analysis will show that the current definition as it applies to natural persons is broadly over-inclusive and needs, at a minimum, to be scaled back. Or it could show that an entirely different approach to the definition is needed.

- Similarly, evidence of broad non-compliance in the crowdfunding market suggests that further analysis is needed before we adopt legislation, however well intended, that could serve to expand retail investor participation in crowdfunding without adequate regulatory protections. We, therefore, urge the Committee to hold off on considering legislation, such as the Crowdfunding Amendments Act, to allow crowdfunding investors to pool their money in a special purpose vehicle, until additional study can be conducted that would help to determine what added regulatory changes may be needed to increase compliance with crowdfunding rules.

- We also oppose the creation of a new class of venture exchanges, which would allow securities of early stage companies to trade without meeting a host of requirements to ensure either that the markets operate fairly or that issuers meet basic standards appropriate for sales to the general public. Among other concerns, these venues are likely to suffer from adverse selection, where high-quality companies “graduate” to national exchanges and the lower-quality companies languish on venture exchanges. Moreover, given how small these companies are likely to be, they are unlikely to attract investment by large institutional investors, who help promote price efficiency in the market. Rather, venture exchanges are likely to be used almost exclusively by retail investors who buy and sell at prices that don’t reflect the companies’ underlying values, and suffer underperformance while holding these lower-quality securities. As a result, retail investors are likely to be the most harmed by venture exchanges.

- **Serious consideration should be given to measures to rein in private offering exemptions.**

Ultimately, we believe that more needs to be done to rein in private offering exemptions and restore an appropriate balance between public and private markets. In particular, we urge the Committee to consider changing the shareholder threshold under Section 12(g) of the Exchange Act to help ensure that large companies with a dispersed shareholder base have to become publicly reporting companies under the ’34 Act. An approach based on beneficial owners, rather than holders of record, would appear to better serve the intended regulatory purpose. We would therefore strongly encourage the Committee to develop legislation in this area. No one can credibly argue that requiring multi-billion dollar companies to provide basic disclosures would impede small company capital formation or impose an unsupportable regulatory burden on struggling businesses.

Another area that deserves additional scrutiny is the Regulation A market, where the SEC did an end-run around Congress in adopting a definition of qualified purchaser that broadly preempted state authority. Given the abysmal results for investors in the Reg A market since the JOBS Act was enacted, the Committee should further consider whether this exemption serves any beneficial purpose in terms of sustainable job creation and capital formation.
Finally, Congress has in a number of areas preempted state authority to oversee private markets without providing the SEC with the resources it would need to fill the gap. The Committee should examine the impact this has had on investor protection and determine what steps are needed to address any concerns – either by restoring state authority or by providing the SEC with additional resources and a mandate to upgrade the extent of its oversight.

This week’s hearing may identify additional proposals deserving Congressional scrutiny to restore an appropriate balance between public and private markets.

Conclusion

One of the signal achievements of the 20th Century was the restoration of trust and confidence in the U.S. capital markets after the cataclysmic events triggered by the 1929 stock market crash. The actions Congress took in the 1930s, creating a regulatory framework based on transparency and accountability, succeeded in creating capital markets that were the envy of the world, engines of a vibrant and growing U.S. economy. Now, however, four decades of policies that promote private capital raising have placed our public markets at risk. Left unchecked, this promotion of private markets at public markets’ expense could recreate the conditions that led to the ’29 crash. We congratulate the Committee for holding this timely hearing on this critically important topic, and we encourage you to follow up with action to restore a healthy balance between our public and private markets.

Thank you for your attention to our concerns.

Respectfully submitted,

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