Speech

Remarks on Capital Formation at the Nashville 36|86 Entrepreneurship Festival

Chairman Jay Clayton

Nashville, TN

Thank you Charlie for that kind introduction. I am delighted to participate in the 36|86 Entrepreneurship Festival here in Nashville, Tennessee. I would like to speak for about 25 minutes about key capital formation initiatives at the SEC.[1] After my remarks, I will be joined by Bill Hinman, the Director of the SEC's Division of Corporation Finance, for a fireside chat that will be moderated by [Tennessee] Governor Bill Haslam. Thank you for joining us today, Governor Haslam.

The 36|86 Entrepreneurship Festival is a fitting place to discuss the Commission's capital formation priorities. While many people visit Nashville because of its rich history and legendary music scene, Bill and I are here today as fans of the Music City's vibrant ecosystem for startups. Nashville's array of incubators, accelerators, co-working spaces, and startup competitions, in combination with active angel investor and venture capital communities, provide fertile ground for startups to get traction and then thrive. Nashville was ranked 6th out of the top 40 U.S. cities for entrepreneurs and startups in 2018,[2] and 7th among U.S. cities creating the most tech jobs in 2017.[3] Sixth and seventh are pretty darn impressive for a city with the 25th largest population.

We should celebrate this success. We also should recognize that Nashville's success stands out geographically. In other words, our innovation and financing "hot spots" are few and far between once you leave a few states on the coasts. In the first quarter of 2018, California, Massachusetts, and New York received more than 78% of all equity financing for venture capital-backed companies.[4] Together, those three states have just 20% of the U.S. population. Compare that to Tennessee and 39 other states that, in the aggregate, received less than 6% of the total.[5] Those 40 states have 45% of the U.S. population. A recent study found that after a period of growth in the number of metro areas across the country experiencing increased venture capital funding, in 2016 and 2017 we reverted back to growth that is greatest on the coasts—in California, Massachusetts, and New York.[6]

There are obviously a lot of miles, many good, talented people, and many promising companies between the coasts, and I want to make sure our regulation of capital formation enables capital to flow to the areas in between. If we see obstacles preventing the efficient flow of capital to these areas, we should be striving to break them down, while at the same time being always mindful of our commitment to investor protection.

In particular, I believe the SEC should be keenly focused on helping small businesses from coast to coast access capital to grow, create new jobs, and, in turn, provide investors, including our Main Street investors, expanded investment opportunities. That is why we have been reaching out to and engaging with businesses across the country. We also should recognize—in our analysis—the many connections among small, medium and large businesses, long-term investment capital and, importantly, human capital.

Focusing on investment capital, we have met with many companies at different stages of the growth cycle and have gained a better understanding of the regulatory and other challenges they face when raising capital. For example, in my first few months at the SEC, we hosted a group of small businesses from across the country, including Arkansas, Idaho, Michigan, Montana, and North Carolina. We discussed the regulatory requirements and other considerations that factor into decisions to stay private or go public, including the complexity of disclosure requirements and the compliance costs of various components of the Sarbanes-Oxley Act of 2002. Last October, Bill [Hinman] and I attended a high-tech jobs summit in Montana to discuss job creation and capital formation. And, last November, the SEC held its annual Government-Business Forum on Small Business Capital Formation in Austin, Texas. This was the first time this event was held outside of Washington, D.C., in more than a decade. I am pleased to be able to continue this ongoing dialogue in Nashville.

I want to now share with you the efforts the SEC has undertaken over the last sixteen months that are intended to foster capital formation, and what you should expect from our upcoming regulatory agenda, both with respect to public, registered offerings, and offerings exempt from registration—"private placements." But before I do so, I want to say a few words about initial coin offerings ("ICOs").

Initial Coin Offerings

No conversation about recent efforts at the SEC to foster innovation would be complete without mentioning our approach to distributed ledger technology, digital assets, and ICOs. Our efforts in these areas embody two key principles the SEC has followed for many decades—(1) embrace new technologies that cut costs and provide new investment opportunities while (2) continuing to require that our retail investors have access to the material information necessary to make an investment decision, including the key risks involved, as well as other fundamental protections.

As I have said before, those seeking to raise capital to fund an enterprise, which many in the ICO space have sought to do, need to consider whether they are engaging in an offer or sale of securities, which places the activity squarely in the SEC's jurisdiction. Determining what falls within the ambit of a securities offer or sale is a facts-and-circumstances analysis, utilizing a principles-based framework that has served American companies and American investors well through periods of significant innovation and change for over 80 years. Bill [Hinman] recently outlined the approach staff takes to evaluate whether a digital asset is a security,[7] and I encourage you to take a look at Bill's speech.

If you are considering jumping into this space, I also encourage you to reach out to the staff in the Division of Corporation Finance. They have built significant expertise on these issues, and recently named a new Associate Director to serve as the Senior Advisor for Digital Assets and Innovation to coordinate efforts in this area across the agency.[8] Our door remains open to those who seek to innovate and raise capital in accordance with the law.

Efforts to Promote Capital Formation for Public Companies and Companies Considering Going Public

Now, switching to our efforts to promote capital formation, I believe the Jumpstart Our Business Startups ("JOBS") Act in 2012 and the Fix America's Surface Transportation ("FAST") Act in 2015, both of which had bipartisan support in Congress, set forth an effective regulatory modernization framework for the SEC to build upon. The JOBS Act and the FAST Act reflect the principle that, in the regulation of public companies, one size does not fit all.

Over the last year, the SEC has taken meaningful steps to reduce regulatory burdens on pre-IPO and smaller public companies, while maintaining and, in some cases, enhancing, investor protections. The importance of this focus is highlighted by the significant decline in public companies over the last two decades, particularly amongst emerging companies.[9] Understanding and addressing this trend—a problem for which, unfortunately, no single policy initiative exists—will, I believe, yield significant benefits for our retail investors as well as emerging companies themselves. For example, investors in these types of companies will have access to investment opportunities in more companies and will benefit from stronger and more complete disclosure than they would likely receive if companies continued to eschew the public markets as a matter of course. This is particularly the case for Main Street investors who generally do not have the opportunity to invest directly in high-quality private companies.

As examples of the SEC's commitment to promoting capital formation, I will highlight three categories of SEC actions in the public company space: (1) scaled disclosure framework for smaller companies, (2) disclosure modernization and simplification, and (3) staff guidance helpful to the IPO process.

Scaled Disclosure Framework for Smaller Companies

For smaller companies to flourish after an IPO, we need to continue to recognize that a one-size regulatory structure for public companies does not fit all. One illustration of right-sizing the regulatory regime is the Commission's June 2018 expansion of the number of companies that qualify as smaller reporting companies ("SRCs").[10] The Commission had established this category of companies in 2008 in an effort to provide regulatory relief for smaller companies by allowing them to provide scaled disclosures, which, in turn, reduces compliance costs. However, the threshold to qualify as an SRC had not been updated for a decade. The new definition enables a company to qualify as an SRC if its public float is less than $250 million (an increase from the previous $75 million threshold). In addition, the final rules expand the definition to capture companies with less than $100 million in annual revenues if they have either no public float or a public float that is less than $700 million. The new definition goes into effect next month and will allow an estimated 966 additional companies to claim SRC status in the first year.

Another area where we should ask ourselves if we have the appropriate framework to support smaller public companies is secondary market liquidity. In April 2018, our Division of Trading and Markets hosted a roundtable that explored the market structure for the securities of smaller, more thinly-traded companies.[11] Our goal is to make sure our market structure meets the needs of all companies—both large and small. The staff is analyzing a number of the suggestions and comments made at that roundtable, and more generally, is considering ways to improve secondary market liquidity for smaller companies.

Disclosure Modernization and Simplification

It is important for the SEC to review our regulations to ensure that they are consistent with our ever-evolving capital markets. These efforts tend not to garner much public attention, but they are particularly consequential with respect to our disclosure rules.

In October 2017, the Commission proposed amendments, as required by the FAST Act, to streamline rules and forms that public companies use to provide information to investors, and also incorporate technology to improve access to information in a manner that reduces the costs to registrants. We received helpful comments, many of them supporting our proposal, and the staff is working on final recommendations for the Commission's consideration.

The Commission also has taken steps to simplify and update financial disclosures. Last month, we proposed amendments to financial disclosures to encourage guaranteed debt offerings to be conducted on a registered rather than a private basis.[12] I believe these measures will save issuers significant time and expense, enhance the quality of disclosure and increase investor protection.

And, just two weeks ago, the Commission adopted final rules that simplify and update disclosures by eliminating requirements that are outdated, overlapping, or duplicative of other Commission rules or U.S. GAAP.[13] While these rule changes may appear technical, I anticipate they—taken together with other capital formation initiatives at the Commission—will yield substantial benefits for public companies and investors. Importantly, they will not adversely affect the availability of material information and, in many cases, will enhance the quality of information and increase investor protection.

Guidance from the SEC's Division of Corporation Finance Helpful to the IPO Process

Commission staff also has been providing guidance aimed at facilitating the IPO process. The JOBS Act gave a new category of companies, emerging growth companies,[14] the flexibility to start the review process for their IPO on a confidential basis. The Division of Corporation Finance expanded this draft submission process to all first-time registrants and newly public companies conducting IPOs and offerings within one year of an IPO.[15] This is significant because it gives registrants more control over their offering schedules and limits their exposure to market volatility and competitive harm, without diminishing investor protection. In the past 13 months, the Division of Corporation Finance has received draft submissions for more than 40 IPOs, and from over 75 companies engaged in offerings within one year of an IPO, that have utilized the expanded accommodation.

The Division of Corporation Finance also provided registrants with guidance on the preparation of financial statements with the goal of identifying areas where flexibility could reduce burdens and costs without materially altering the total mix of information available to the public. In particular, the staff provided greater clarity about what financial information is required when submitting draft registration statements, which has allowed registrants to avoid the time and expense of preparing and filing interim financial information that will be superseded by the time the filing is first made publicly available.[16] The Division of Corporation Finance, in combination with our Office of the Chief Accountant, also provided guidance promptly after enactment of the Tax Cuts and Jobs Act, anticipating that registrants would face challenges to account for a very significant change to the U.S. federal tax code.[17] I applaud them for their pro-active perspective and substantive quality of their efforts.

Next on Our Agenda for Public Companies

Despite all of the recent efforts at the SEC, I believe more must be done to encourage capital formation for emerging companies seeking to enter our public capital markets. Over the next several months I expect the Commission will be taking a fresh look at the thresholds that trigger Section404(b) of the Sarbanes-Oxley Act of 2002, which requires certain registrants to provide an auditor attestation report on internal control over financial reporting (“ICFR”).

While Section 404(b) is an important component of our public company regulatory regime, we have heard from market participants and our former Advisory Committee for Small and Emerging Companies that, particularly for smaller companies, the costs associated with this requirement can divert significant capital from the core business needs of companies without meaningful benefit.

Currently, companies with a public float of less than $75 million, or, if no public float, annual revenues of less than $50 million, have relief from the Section 404(b) auditor attestation requirements. Importantly, and I believe that this is often misunderstood, those companies are still required to establish, maintain and assess the effectiveness of ICFR,[18] and, even if not engaged to report on ICFR, independent auditors are still responsible for considering ICFR in the performance of their financial statement only audits.[19] In considering ICFR, independent auditors can better plan their audits and provide management and audit committees with observations about the company’s ICFR.[20] I believe this scaled approach has proven to be appropriate for smaller reporting companies and again reflects the perspective that one size regulation of public companies does not fit all. Note that our 50th largest exchange-listed company has a market cap of approximately $100 billion, while the median exchange-listed company has a market cap of less than $1 billion.[21] There are more than 1,200 exchange-listed companies with a market cap of less than $250 million.[22]

I also believe there may be other categories of small and emerging companies where a scaled approach may be appropriate. For example, for a biotech company with routine financial statements and no revenue, the money that goes to pay for the Section 404(b) auditor attestation report could instead be used to hire new scientists to advance life-enhancing or life-saving developments. I have directed Commission staff to formulate recommendations for possible amendments that would reduce the number of companies that need to provide the auditor attestation report required by Section 404(b) while maintaining appropriate investor protections,[23] and they are actively working on that project. I look forward to considering the staff’s recommendations.

In addition, the staff is working on a recommendation to expand the ability of companies who are contemplating raising capital to “test the waters.” The JOBS Act permitted emerging growth companies to test the waters, that is engage in communications with certain potential investors prior to or following the filing of a registration statement for an IPO.[24] I have seen firsthand how this has benefitted companies considering an IPO, as they are able to engage investors earlier to explain their business and obtain feedback in advance of an offering. This also benefits investors and shareholders as companies are better able to determine the appropriate time for an offering and to more effectively size and price the offering. I look forward to the Commission considering this initiative in the coming year.

Rethinking our Exempt Offering Framework

Now let me shift away from public companies, because capital formation is equally important for private companies—including many of the entrepreneurs here today in Nashville. We need an environment that nurtures the growth of a company throughout its business cycle, from the idea planted while talking with friends over dinner, to the launch of the business, to the pains that come with growth, to maturity and profitability.

Congress and the SEC have taken a number of steps to expand the options that small businesses have to raise capital. Small businesses today have more options to reach investors within their state using the intrastate exemption,[25] or tap the “crowd” using the power of the Internet through Regulation Crowdfunding offerings.[26] Small businesses can decide to limit their offerings to sophisticated investors in reliance on Regulation D,[27] or open those offerings to retail investors using Regulation A.[28] Since these rules have gone into effect, small businesses have conducted over 900 offerings that reported raising more than $90 million collectively using Regulation Crowdfunding.[29] And there have been over 300 offerings that reported raising a total in excess of $1 billion pursuant to Regulation A.[30] Those amounts, however, are eclipsed by the $147 billion reportedly raised in 2017 using Rule 506(c) of Regulation D, the new exemption that lifted the ban on general solicitation. And even that is dwarfed by use of the traditional private placement exemption in Rule 506(b) of Regulation D to raise over $1.7 trillion in 2017.[31]

Additionally, the SEC recently expanded the exemption that permits private companies to issue securities to employees, consultants, and advisors as compensatory awards—a transaction that preserves cash for the company’s operations and aligns the incentives of employees with the success of the company—and is soliciting comment on further ways to modernize the rules related to these compensatory arrangements.[32] The so-called “gig economy” has changed how companies and individuals design alternative work arrangements, and, therefore, individuals may not be “employees” eligible to receive securities as compensatory awards under our current exemption. I encourage all of you to review the concept release and provide us with feedback on how we can improve our rules.[33]

While the options to raise capital in exempt offerings have grown significantly since the JOBS Act, there has not been a comprehensive review of our exemptive framework to ensure that the system, as a whole, is rational, accessible, and effective. In fact, I doubt anyone would have come up with anything close to the complex system we have today if they were starting with a blank slate. So, I believe we should take a critical look at our exemption landscape, which can be fairly described as an elaborate patchwork. As we embark on this project there are a number of things we should consider.

- We should evaluate the level of complexity of our current exemptive framework for issuers and investors alike, and consider whether changes should be made to rationalize and streamline the framework.
    - For example, do we have overlapping exemptions that create confusion for companies trying to navigate the most efficient path to raise capital?
    - Are there gaps in our framework that impact the ability of small businesses to raise capital at key stages of their business cycle?
- We also should consider whether current rules that limit who can invest in certain offerings should be expanded to focus on the sophistication of the investor, the amount of the investment, or other criteria rather than just the wealth of the investor.

- And we should take a look at whether more can be done to allow issuers to transition from one exemption to another and, ultimately, to a registered IPO, without undue friction.

The staff is working on a concept release that I expect will bring to the forefront these and other topics on how we can harmonize exempt offerings. Input from you, the startups, entrepreneurs and investors who have first-hand experience with our framework, is extremely important to make sure we get it right.

I hope you will take the time to share your views with us on this topic and any other topic where you feel we can improve.

Conclusion

To sum up my remarks in a sentence, we have taken a lot of steps intended to promote capital formation, and we have an ambitious capital formation agenda ahead of us. The SEC is committed to efforts to develop a regulatory framework that equally serves the neighborhood coffee shop that is looking to expand into a second location, the biotech startup looking to hire more scientists to cure cancer, the social media company looking to conduct its IPO, and the Main Street investor saving for their future.

Bill Hinman and I, and the Governor, look forward to our conversation with you. Thank you for your attention and thank you in advance for your questions and comments.

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[1] My words are my own and do not necessarily reflect the views of my fellow Commissioners or the SEC staff.

[2] Bill Frost, *The Top 10 US Cities for Entrepreneurs and Start-Ups in 2018*, Business.org (June 21, 2018), *at* https://www.business.org/business/startup/top-cities-for-entrepreneurs-and-startups/ .

[3] Joel Kotkin and Mark Schill, *The Cities Creating the Most Tech Jobs 2017*, Forbes (March 16, 2017), *at* https://www.forbes.com/sites/joelkotkin/2017/03/16/technology-jobs-2017-san-francisco-charlotte-detroit/#37c1f6138f6b .

[4] *MoneyTree Report Q1 2018*, PwC/CB Insights, *at* https://www.pwc.com/us/en/technology/assets/MoneyTree_Report_2018_Q1_FINAL.pdf .

[5] *Id*.

[6] Ian Hathaway, *America's Rising Startup Communities*, Center for American Entrepreneurship (July 2018), *at* http://www.startupsusa.org/americas-rising-startup-communities/ .

[7] William Hinman, Digital Asset Transactions: When Howey Met Gary (Plastic). Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018), *at* https://www.sec.gov/news/speech/speech-hinman-061418.

[8] *See* Press Release 2018-102, SEC Names Valerie A. Szczepanik Senior Advisor for Digital Assets and Innovation (June 4, 2018), *at* https://www.sec.gov/news/press-release/2018-102.

[9] The total number of exchange-listed operating companies in June 2018 was approximately 4,300, compared to about 7,400 in December 1998. In June 2018, approximately 1,000 exchange-listed operating companies had market capitalization between $250 million and $1 billion—there were approximately 1,500 companies within that range in December 1998. Based on information from the Center for Research in Securities Prices, The University of Chicago Booth School of Business.

[10] *See* Press Release 2018-116, SEC Expands the Scope of Smaller Public Companies that Qualify for Scaled Disclosures (June 28, 2018), *at* https://www.sec.gov/news/press-release/2018-116.

[11] *See* Press Release 2018-65, SEC Staff to Host Roundtable on Market Structure for Thinly-Traded Securities (April 13, 2018), *at* https://www.sec.gov/news/press-release/2018-65.

[12] *See* Press Release 2018-143, SEC Proposes Rules to Simplify and Streamline Disclosures in Certain Registered Debt Offerings (July 24, 2018), *at* https://www.sec.gov/news/press-release/2018-143.

[13] *See* Press Release 2018-156, SEC Adopts Amendments to Simplify and Update Disclosure Requirements (Aug. 17, 2018), *at* https://www.sec.gov/news/press-release/2018-156.

[14] Rule 405 under the Securities Act [17 CFR 230.405] defines an emerging growth company as an issuer that had total gross revenues of less than $1.07 billion during its most recently completed fiscal year. It retains that status for five years after its initial public offering unless its revenues rise above $1.07 billion, it issues more than $1 billion of non-convertible debt in a three year period, or it qualifies as a large accelerated filer pursuant to Rule 12b-2 under the Exchange Act [17 CFR 240.12b-2].

[15] Draft Registration Statement Processing Procedures Expanded, Division of Corporation Finance Announcement (June 29, 2017) [Supplemented Aug. 17, 2017], *at* https://www.sec.gov/corpfin/announcement/draft-registration-statement-processing-procedures-expanded.

[16] Securities Act Forms Compliance and Disclosure Interpretation 101.04 and 101.05, *at* https://www.sec.gov/divisions/corpfin/guidance/safinterp.htm.

[17] Staff Accounting Bulletin (SAB) No. 118, *at* https://www.sec.gov/interps/account/staff-accounting-bulletin-118.htm. *See also* Exchange Act Form 8-K Compliance and Disclosure Interpretation 110.02, *at* https://www.sec.gov/divisions/corpfin/guidance/8-kinterp.htm.

[18] Exchange Act Rules 13a-15 and 15d-15.

[19] PCAOB Auditing Standard (“AS”) No. 2110, Identifying and Assessing Risks of Material Misstatement, paragraphs .18 - .38.

[20] *Id*. *See also* AS No. 1305, Communications about Control Deficiencies in an Audit of Financial Statements.

[21] Based on information from the Center for Research in Securities Prices, The University of Chicago Booth School of Business.

[22] *Id.*

[23] *See* Smaller Reporting Company Definition, Release No. 33-10513 (June 28, 2018) at 6-7 [83 FR 31992 (July 10, 2018)], *at* https://www.sec.gov/rules/final/2018/33-10513.pdf.

[24] Pub. L. No. 112-106, 126 Stat. 306 (2012).

[25] *See* Intrastate offerings, *at* https://www.sec.gov/smallbusiness/exemptofferings/intrastateofferings.

[26] *See* Regulation Crowdfunding, *at* https://www.sec.gov/smallbusiness/exemptofferings/regcrowdfunding.

[27] *See* Private placements—Rule 506(b), *at* https://www.sec.gov/smallbusiness/exemptofferings/rule506b. *See also* General solicitation—Rule 506(c), *at* https://www.sec.gov/smallbusiness/exemptofferings/rule506c.

[28] *See* Regulation A, *at* https://www.sec.gov/smallbusiness/exemptofferings/rega.

[29] Based on data reported by filers in EDGAR as of June 30, 2018.

[30] Based on data reported by filers in EDGAR as of June 30, 2018.

[31] Based on data reported by filers in EDGAR for the year ended December 31, 2017.

[32] *See* Press Release 2018-135, SEC Adopts Final Rules and Solicits Public Comment on Ways to Modernize Offerings Pursuant to Compensatory Arrangements (July 18, 2018), *at* https://www.sec.gov/news/press-release/2018-135.

[33] *Concept Release on Compensatory Securities Offerings and Sales*, Release No. 33-10521 (July 18, 2018) [83 FR 34958 (July 24, 2018)], *at* https://www.sec.gov/rules/concept/2018/33-10521.pdf.