UNITED STATES SECURITIES AND EXCHANGE COMMISSION

SMALL BUSINESS ADVISORY COMMITTEE MEETING

Tuesday, February 7, 2023

Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

PARTICIPANTS:
Commissioner/Chair Gary Gensler
Commissioner Jaime Lizarraga
Commissioner Mark Uyeda
SEC Committee Members:
Carla Garrett
Jeffrey M. Solomon
Gregory Yadley
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Donnel Baird
William M. Beatty
Kesha Cash
Greg Dean
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Robert Fox
Stephen Graham
Sara Hanks
Brian Levey
Sapna Mehta
Catherine Mott
Jason Seats
Marc Oorloff Sharma
Hank Torbert
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PARTICIPANTS(CONT.):

Presenters:
Damien Dwin, Founder and CEO, Lafayette Square
Melissa Withers, Managing Partner, RevUp Capital
Alpa Patel, Partner, Investment Funds, Kirkland & Ellis LLP
Charles Hudson, Managing Partner & Founder, Precursor Ventures
Charles K. Bobrinskoy, Vice Chairman, Head of Investment Group and Portfolio Manager, Ariel Investments
Amy Natterson Kroll, Partner, Morgan Lewis

C O N T E N T S

P R O C E E D I N G S

MS. GARRETT: I call this meeting to order.

COURT REPORTER: I'm sorry, the audio keeps on fading out. I don't know if anyone else is experiencing it. This is the Court Reporter. I can hear the first few syllables and then it fades out.

MS. GARRETT: I will try that again.

I would like to extend a special thank you to the Chair and the Commissioners for attending today's meeting. And I want to thank the staff of the Office of the Advocate for Small Business Capital Formation who play an integral role in having these meetings come together.

Our agenda today will be as follows. We will first hear remarks by Chair Gensler and the Commissioners. Following the remarks we're going to take the opportunity to share committee member updates on challenges and opportunity for small businesses raising capital in 2023. And we will go around the room and hear from each member.

After that our first agenda item is alternatives to traditional bank and venture capital funding for small businesses.

And then we will discuss the Commission's proposed rules and amendments related to the regulation of private fund advisors, with a particular focus on how the proposed rules would impact small funds.

We expect to break for lunch around 12:40. In the afternoon we will discuss the role of investment research prepared by broker/dealer firms for smaller public companies. We have lined up great speakers to present on all of these topics and I look forward to the committee engaging in discussions with them.

I also want to recognize that many of us here on the committee were inaugural members appointed by the Commission in April of 2019 when the committee was created. I would be remiss not to note that today is the final meeting for many of us as our four year terms draw to a close, including mine and my Vice-Chair Jeff Solomon. Therefore, later this afternoon we would like to discuss some parting perspectives from the committee to the Commission.

Before we turn to our agenda items we are pleased to first recognize Chair Gensler and the Commissioners who are here today for opening remarks.

Chair Gensler?

COMMISSIONER/CHAIR GENSLER: Thank you so much and good morning and it’s good to join the advisory committee for this first meeting of the year. As you also said, many of the members, I think it’s actually 13 of you who are concluding your terms with the committee the nature of this four year term.

So, I can't thank you all enough for your service, for your advice, for your counsel, to the SEC as we've sorted through how to ensure that our capital markets work not only for investors but also issuers and amongst those issuers, small issuers as well as large issuers.

Of course, I'd like to note that by views are my own and I'm not speaking on behalf of the Commission or the SEC staff. I do appreciate that later today you'll also be getting from the members that are ending their journey, sharing parting perspectives.

Before that, of course, though you're going to be discussing the benefit of this agenda is alternatives to traditional bank and venture capital funding for small companies. Our proposal, as your mentioned, related to private fund advisors and the role of equity research for small companies.

I'm just going to share a few thoughts on the private funds, if I might, and look forward to hearing what you have to say on the other two. But the Commission made a proposal about a year ago, last February, regarding private fund advisors. Now, these funds include hedge funds, private equity, venture funds, liquidity funds. And currently there are just a touch around $21 trillion in gross assets.

And why do I mention that? Because given their relative growth these funds actually will soon surpass our entire commercial banking sector which is $23 trillion. These are both big numbers but the private fund space is nearly identical and is likely to pass the entire commercial banking sector soon.

So, why do private funds and their advisors matter? Because basically all the people that stand on either side of those funds; the people whose assets are invested in private funds are often teachers and firefighters, municipal workers, students, professors and the like. But on the other side are people raising money from private funds. And they might be start-up entrepreneurs, small business owners or managers of late scale companies, all across our capital system, $21 trillion in the middle.

And the advisors to that space, the advisor to that space may be for them taking $250 billion to $300 billion of fees and expenses each year. That’s not an inconsequential number to our economy but also that a money that portfolio companies like small businesses, you know, in essence don’t get to use. Because it’s the intermediation between the investors on the one side and the businesses on the other.

And though fees among other funds such as mutual funds and exchange traded funds have actually had significant reductions in recent years due to modern technology, competition, efficiency. Private fund fees have not come down in comparable ways. Given that these funds touch so much of our economy, efficiency and competition among these intermediaries is important.

And that’s why I supported our proposal. Again, this is about a year ago, to require registered private fund advisors provide detailed reporting to investors on fees, on expenses, on performance and preferential treatment such as side letters.

A lot of disclosure to the limited partners whose money the investors are putting up, driving hopefully greater efficiency competition transparency in this space.

More competition, transparency could bring greater efficiencies, of course. Such efficiency could help the people and entities on both sides; the investors on one side, the small and medium and large businesses on the other.

So, I look forward to hearing from the committee on this proposal. Of course we’ll put this in the comment file. And I thank you and turn it back.

MS. GARRETT: Thank you Chair Gensler.

And next we will hear from Commissioner Uyeda who is here with us today.

COMMISSIONER UYEDA: Well, thank you very much for that, Carla.

Good morning and welcome back to the SEC. I was really excited. This is I think the second time since the pandemic started that this committee has gathered in person.

So, I really appreciate seeing everyone here, but also appreciate the importance of our ability to do things in a hybrid manner to make sure we get full participation from all who can.

I'd like to start by thanking committee members whose terms will be ending. I can't believe four years have gone by so quickly. And some of you I remember working with even on your prior iterations when we were a predecessor committee was operating under the Federal Advisory Committee Act. So, I know there are some familiar faces. For some of you it's been four years and I know others it's been every longer service to the public in your capacity. So, thank you for all of that.

Your commitment to spend time outside of your day jobs and your input on the challenges facing small businesses, emerging companies and smaller public companies has been greatly appreciated, especially by folks like me who really have a passion for capital formation and helping the small business.

Your discussion and advice doesn't stop, hasn't stopped yet. Today is very important and you've got some great panels on very relevant topics. On that point I thought I would just share a couple thoughts on today's agenda.

First, the committee will be discussing alternate traditional financing for smaller public companies. These companies likely gave challenges in securing funds from venture capital firms because these firms often do not focus on companies below a certain valuation or that seek a relatively small investment amount.

Revenue-based financing and other alternatives may only partially fill this void for small public companies. Without these alternatives smaller companies may have fewer sources of funding which can lead to higher costs of capital. I am hopeful that these alternatives will help fund small businesses including those founded by women and minority entrepreneurs.

As detailed in the most recent report from the Office of the Advocate for Small Business Capital Formation, those groups have faced significant challenges in receiving venture capital financing. When making recommendations to the Commission for alternatives to traditional financing, the committee should also take into account the practical availability of such alternatives to small businesses.

Second, the committee will discuss the Commission’s February 2022 proposal on private fund advisors as the Chair just mentioned. The proposal includes, among other things, requiring advisors to distribute a quarterly statement detailing information about private fund performance; private fund performance, fees and expenses, to obtain financial statements of their advised funds. Obtain a fairness option in connection with advisor led secondary transactions and prohibit private fund advisors from engaging in certain kinds of activities and entering into side letters with their investors.

I was not a commissioner at the time of the proposal. And I am concerned whether the proposal's approach to private fund advisor oversight is consistent with our three part mission to protect investors, maintain fair and orderly markets and facilitate capital formation.

I think it's also very important that we don't have rules that are one size fits all and that treat the $5 billion fund in the same manner as the $50 million fund. And I think this is a very important area. And, you know, for instance even in the past with respect to our marketing role. I think there are some real challenges in implementing that and especially when it comes to smaller funds and smaller fund advisors.

So, ultimately my views on any final role with be informed by the public's feedback including recommendations of this committee. Finally, the committee will discuss the role of equity research for smaller public companies.

Nearly 20 years ago 10 cell site financial firms entered into what is known as the global settlement with several securities regulators including the Commission. The global settlement required these firms to separate their research and investment banking departments. Smaller companies asserted that their research coverage has declined or had been discontinued due in part to increased regulation and compliance costs caused by the global settlement.

While the conflicts from cell site research as well known, what is not discussed is the effects when these cell site firms withdraw from providing research to the market leaving an information vacuum that begs to be filled by other outlets like social media and online forums. Are retail investors really better off in that environment? A review of the effects of this 20 year old local settlement is long overdue.

So, I’m confident that the committee’s discussions during these panels will generate ideas and recommendations to the Commission to consider. Once again, thank you to all the committee members for your service and your passion to help address the unique challenges faced by smaller companies.

MS. GARRETT: Thank you, Commissioner Uyeda.

And next we have with us remotely we have Commissioner Lizarraga. Welcome.

COMMISSIONER LIZARRAGA: Good morning and thank you, Carla and the rest of the committee for your time and input today.

As Chair Gensler and Commissioner Uyeda mentioned, this will be the last meeting for several committee members who have reached the end of their terms. Thank you for your service and for the time and contributions you have made over the past several years.

For those who will continue to serve on the committee, I urge you to redouble your efforts in partnership with the incoming members to advise us on the most innovative ways to better serve truly small businesses and entrepreneurs. It is those in our country's undeserved communities that have been largely ignored.

To me, these businesses are the true unicorns with an exceptional entrepreneurial spirit representative of the best traditions of American ingenuity. But these face barriers to accessing venture and capital ecosystems and networks, and to our capital markets more generally. Growth oriented companies, particularly in the high tech sector, are well supported by the current regulatory system and by the focus of the policy debating forums like these.

But these well resourced companies are in less need of our attention than the millions of small businesses that the current capital formation system fails to support. And while the larger growth oriented companies are important drivers of jobs and innovation, so are the truly small businesses that are being left out.

I hope and expect that the expertise represented on this committee can elevate to the forefront the needs of businesses with other types of characteristics, balance sheets and models for growth. It is also my hope that the committee’s work will result in direct recommendations to the Commission on the best ways to address these challenges meaningfully and effectively.

In the absence of broad based access to growth capital for our nation’s smallest, most undeserved businesses fulfillment of our capital formation mission will fall short of its full potential. Thank you for your service and for your contributions to today’s discussion.

MS. GARRETT: Thank you.

Thank you, Chair Gensler and Commissioners for being here with us today and for your remarks.

We’re going to move on to committee members’ outlook. We find ourselves in a challenging national economy given that the time seems particularly right for committee members to go around the room and for us to hear from our adverse geography’s perspectives and marketplaces that this group represents. If each member can take up to three minutes to share your perspectives on the challenges and opportunities for small businesses raising capital in 2023, that would be appreciated.

I will start off and I will probably make my observations short so everybody else has time to speak. I am a corporate attorney that advises small businesses and I have seen significant slow down in M&A activity especially in the government contractor sector we've seen considerable slowdown in M&A deals. And we think it's possibly as a result of the uncertainty around budget cuts the new congress may make and the uncertainty over the debt ceiling.

In addition, we have found that funding is much harder to get for small companies right now. Companies that were able to raise funds both quickly and inexpensively last year are facing much harsher conditions right now, especially in the emerging company sector.

Overall, then we are seeing a much harder time for smaller companies to find funding and liquidity and we've seen that from late 2022 and so far in 2023.

Jeff?

MR. SOLOMON: Thanks, Carla.

I'm Jeff Solomon; I'm the Chair and CEO at Cowen. From our perch we're certainly seeing definitely increased stress in small businesses particularly given the rising rate environment. And so, it's probably more compelling than ever to continue to have opportunities for companies to finance themselves using equity. It's less risky to their long term survivability. Obviously we need to be in a position where we're continuing to have capital flows. At the same time we need to make sure that investors who've invested in these companies and through vehicles that invest in these companies are protected.

So, I think when we look at the bigger macro picture, United States has a significant amount of capital investment that needs to be made over the course of the next decade. Primarily it sometimes can be framed as a matter of national security or just creating supply chains, particularly in the technology sector that are so critical for us to have here in the United States. And all of that requires significant amounts of capital; debt capital, equity capital.

And much of that work will be done by smaller companies that sell into larger manufacturers. So, when you think about how the -- that's a good first start, but it's small, right? And so, the government will have some role to play in being able to start the process. But if we don't get the private sector to step up and create mechanisms for having capital to invest in critical industries like semiconductors or healthcare, technology companies that are critical to the U.S. infrastructure going forward, we're going to end up in a situation where we've exceeded our position as a country for the best capital markets.

And I've said over and over again in this committee, and I think our last four years has demonstrated this, if we treated our capital markets like a national resource we'd have a very different approach to the way we do it.

So, I think the SEC has a hard job. The three prong test is not an easy thing to balance. I certainly don't, I look at the commissioners and the staff here and I know they spend all day every on it. But I think the thing I would say is if we look out over the next decade we have to make sure that capital continues to flow to small companies, not just because of what it does for employment but what it does for national security and what it does for our ability to be competitive as a country going forward.

So, whatever we think about let's make sure that we protect investors 100 percent otherwise we can't do anything. And let's make sure that the capital is still able to flow in ways where small businesses can flourish.

MS. GARRETT: Thank you, Jeff.

Greg?

MR. YADLEY: Thank you.

Greg Yadley, I'm a lawyer in private practice in a medium sized firm in Tampa, Florida and have been active in both the Florida Bar and the American Bar Association.

I agree with the comments so far. Capital is not flowing as readily in part because of uncertainty. Beyond the SBA bank, lending is not robust. I think some macro factors such as the decline in the number of community banks and also the lack of collateral for smaller companies, of a number of small companies that have already maxed out their two and three credit cards and they're now calling up with questions about insolvency. Venture capital and private equity are great but they are not focused on start-ups. So, friends and family and angels continues to be the greatest source of capital.

I would just like to comment on something maybe a little different, but focusing on the people who are asking for capital. There are a lot of practical issues. Sometimes it's just a lack of knowledge and I would very much like to commend the Office of the Advocate for Small Business Capital Formation because I think you all have been very creative in basic information that doesn't talk down to people. It's very accessible and it's easy to understand, but there is still a lot of confusion in part because there are so many exemptions from registration.

The professionals aren't always the answer. There are lawyers out there who are dabbling in securities law. It's a private placement. We don't have to worry about anything. And it's not that they're top act in an unprofessional manner, it's just they don't know what they don't know. And they don't focus much on state law issues. Bad actors, they sort of know it's out there but they don't really know what it means. Form D, there are just so many forms they use.

On the other hand, some lawyers who are very knowledgeable are too academic and not very practical. Intermediaries, there are lots of people out there who have been successful or purport to be successful and they’re willing to help companies with introductions. And they won’t even get paid unless they raise the money. Well, that person is probably an unregistered finder and that’s a huge problem.

Naivete, people who have inflated ideas unrealistic about what their company’s worth. How to price equity, they’ve done little financing that have really complicated their capital structure. They have all these weird instruments and lots of investors went off deals and now they have a service and an idea and they spend their first hours with us unwinding these mistakes.

Many of them also reflect their unsophistication by bringing me documents from their angel and the documents are very one-sided and they favor the angel. So, that’s not really crooked either, but I am not cynical.

I think that the work that this committee has done has identified a lot of low hanging fruit. We have a lot of recommendations. The staff is attuned to the issues and thank you to the commissioners and the chair who are here and are listening because I think we can make progress. It doesn’t have to take years and I look forward to being part of the effort. Thank you.

MS. GARRETT: Thank you very much, Greg.

Donnel?

MR. BAIRD: Good morning. My name is Donnel Baird. I’m the CEO of a VC backed climate tech start-up called Block Power. We say that we turn buildings into Teslas meaning that we rip all the fossil fuels out of buildings and replace it with all electric devices. That was a popular phrase last year, less these days.

We focus in financially under-served communities which I think is really relevant to these conversations as we’ve learned a lot about what it means to try to be of service in a financially under-served community. In D.C. the normal response is, oh well, we have CDFIs through the Department of Treasury and the Federal Reserve banking system. And I became so interested in CDFIs that I actually joined an advisory board at the New York Fed where we spend a lot of time talking about this.

But they don’t actually work to provide capital that’s scale to small businesses in financially under-served communities. And I couldn’t agree with Greg more wholeheartedly that, you know, venture capital and private equity in some of these sources have also failed to provide capital in financially under-served communities. We saw that. Whereas traditionally we went in and people of color were able to raise three percent of venture capital. That’s gone down to one percent last year.

You know at my company we have been fortunate, we’ve raised about $40 million or so in VC and $200 million of debt. We also used SEC exemptions to raise $4 million of crowd funding through the Reg CF which was interesting. And so, we have learnings to share there, it works great for us.

I think there’s massive opportunities that I’m really looking forward to discussing with the committee this year. I think the climate disclosure work that we’re doing is monumental. Yes, there needs to be tweaks and I know we’ve discussed that, but I think it’s so important. And I do think that the innovation sector in America will rise to the challenge to help large businesses and their suppliers alike meet the new, I was going to use the work burden, I’m not going to use that. Meet the new climate disclosure requirements that are being proposed because I think it’s a really important opportunity that can fuel growth and actually not be a burden.

I think last, I would add from the perspective of financially under-served communities the CHIPS Act was mentioned. Jeff mentioned that. The Bipartisan Infrastructure Bill and the IRA are just massive, massive opportunities to provide financial services to communities that have been financially under-served.

In particular, in the IRA Justice40, which President Biden signed, where 40 percent of all the capital invested in the IRA is supposed to flow into financially under-served communities. Well, how are we going to provide capital to the small businesses that need to be scaled up to meet that moment and meet that opportunity and support the administration as they make these investments?

We don’t think that traditional small business banking or CDFI banking or VC or private equity is going to do it. And so, I am very interested in continuing to explore what we can do to ensure that American small businesses are capitalized to meet the moment of the Inflation Reduction Act. Thank you.

MS. GARRETT: Thank you, Donnel.

Bert?

MR. FOX: Thank you. I’m Bert Fox and I’m a partner in Grant Thornton, one of the leading audit accounting tax providers, consulting providers her in the U.S., in the world.

I agree with all the remarks so far; a couple of additional comments. One is, you know, we’re seeing a lot more of the actual non-traditional financing coming to play, the deals we are seeing getting done. The traditional banks, even the large ones are stepping away. And the private equity backed lenders are stepping in. A lot of that is because of certainty of financing and certainty of close. And so, we are seeing, you know, back to Commissioner Gensler's comments this morning, you know, for better for worse. A lot of the even first and second lien being taken by the non-traditional lenders right now.

I also think it's a tale of two or three economies right now. I think that while there's an economic slowdown that was referenced earlier, there's also a lot of dislocation that's come out of the pandemic. Even businesses like Donnel's and others I think, you know, there's a lot of growth and there's still a lot of sectors we're seeing that are very hot and deals are happening. But then others they're not. And so, it does seem to be an economy of have and have-nots or it's also some of that dislocation.

The last comment I'll make is that, you know, and this reflects back to Jeff's comments earlier, it does seem like the deal activity we're seeing both in the VC and private equity space as well as strategic buyers is much more in the recurring revenue space. In fact, even a lot of private equity on the smaller side is actually, you know, somehow HVAC and climate control companies have become a hot investment roll-up, right?

And, again, a lot of it because of certainty of revenue, certainty of investment, maybe not the most, you know, astronomical potential returns but there’s a lot of guarantee there. And in the world of uncertainty right now that’s what investors are looking for. It does make me wonder, make to Jeff’s comments, you know, do we have people willing to make those bets on the much more uncertain outcomes that maybe we as the, as an economy and a nation need to be able to fund, right, versus the, you know, given all the other economic uncertainty, right?

And so, I think with all the people that are in here we’ll probably have some good ideas on that. But just in terms of observations those are some of the things I’ve seen and that haven’t been mentioned.

MS. GARRETT: Thank you, Bert.

Sara?

MS. HANKS: Thank you.

Sara Hanks, I’m CEO of CrowdCheck and CrowdCheck Law and we provide a wide range of legal and compliance services in the online capital formation world. So, we’re dealing with the exemptions from registration under Regulation A, Regulation CF, Rule 506(c).

We’re really seen a noticeable falloff maybe from about September of last year in this market. And people have tried to ascribe this to the wider falloff in VC and the IPOs and the like. I think that there’s something else going on there and I’m speculating and it’s purely speculation that some of this is driven by the crypto business and the people who were feeling flushed because they have loads of NFTs and Bitcoin in their wallet before it got stolen are now not investing in real companies. I’m sorry, I’m a crypto sceptic.

But, you know, I’m purely speculating here because there’s no research. And one of the things that we have in this market is we have a lot of visibility into the sellers, you know, who are the companies. There’s a couple of outfits out there; KingsCrowd and CrowdFund Capital Advisors, getting very good information about, you know, where the issuers are and what industry they’re in and minority women. But we’re not really getting any information about where the investors are. And I think that would be a very useful thing because those investors are people we need to protect obviously.

Along those lines, another challenge I just wanted to flag and throw out there is that we’ve seen more and more use of SAFEs and similar variations on SAFEs. There are so many variations on this Simple Agreement for Future Equity out there that I think there’s a lot of cases in which issuers don’t understand what they’ve signed up for, and investors don’t understand what they’re bought.

And then one final challenge I would like to recognize and then throw over to the staff, these are new,

new exemptions. There is no limit to the ingenuity of the American entrepreneur. They are always going to find some way of saying well, what if we do a Reg S here and we do Reg A here and we do Reg D there and we're spending all out time with our brains exploding, coming over to the staff going hey, we got a new one for you. It's time for a whole series of compliance and disclosure interpretations especially from -- but from the other division as well, please.

MS. GARRETT: Thank you, Sara.

And next we're going to have Brian Levey who is on remote with us.

Welcome, Brian.

MR. LEVEY: Thanks, Carla.

For those who don't know me I'm Brian Levey, Chief Business Affairs and Legal Officer at Upwork, which is a work marketplace for remote talent that caters to small and medium sized businesses. I should not that these views are my personal views and not those of Upwork.

So, a friend who happens to be a brilliant economist recently conveyed some of his speculative thoughts on the potential impact of ChatGPT and the other new AI developments that have taken the world by storm over the last month or two.

I have tried to apply his highest level take-aways and frame them more narrowly to how I think they might directly affect the small business capital formation ecosystem in 2023 and beyond, for the better and for the worst.

So, as far as the upsides, maybe the best way my economist friend describes it is at the marginal cost of a certain kind of information generation activity is now close to zero. It seems in a relatively short order this type of technology will provide remarkable good results for most requests. It follows that these developments will over time almost certainly make small businesses more productive and hopefully democratize capital raising to a greater extent across the country.

In short, small businesses will much more easily be able to create a business plan, marketing materials, conduct competitive analyses and generate other useful materials in connection with their capital raising efforts. Of course, things will need to be cleaned up and edited. But it appears that small businesses will be able to start with gray or at least good enough material generated by this AI in a much quicker and less expensive manner than ever before.

As far as the downsides, my economist friend suggested that the cost of creating more plausible sounding falsehoods or as he likes to call it, BS, is not effectively zero too. And that will mean a lot more of it, particularly for products and services that depend on people believing BS which is certainly always a risk in many environments including, among others, the capital raising world.

Yes, literally overnight creating fake materials to dupe potential investors has become easier. And as a result many kinds of fraud will be cheaper now to commit too, including what is likely to be more believable fraud in the capital raising space that is committed not just on the most gullible small investors anymore.

So, in sum, while I think the benefits of this new technology will far outweigh the costs when it comes to accelerating small business capital formation, regulators and investors will need to be wary of the bad actors out there who may also see the initial benefits of using AI to participate in deceit and fraud until it isn’t. So, some food for thought. Thank you all.

MS. GARRETT: Thank you, Brian.

Sapna?

MS. MEHTA: Thank you everyone. I am Sapna Mehta and I’m GC of the Rise of the Rest Seed Fund which is one of the revolution funds. We’re local in D.C. We have about 200 portfolio companies and so we’ve seen a lot of shifting market dynamics across sectors.

You know, to reiterate what others have said, we have certainly seen a dramatically changed environment as of the end of 2022. There are certain sectors that seem to be doing very well and as Bert said, you know, a lot of these SES companies seem to be staying on course. And a lot of seasoned founders, you know, raised money last year when we saw what was likely to start happening this year.

But we are seeing a lot of companies that were doing very well, especially in the consumer sector and a few other sectors but, you know, had no problem raising cash before at increasing valuations and who are now having much more trouble raising money at attractive valuations. So, we’re seeing a lot more flat rounds, down rounds, some pay to plays and then more, you know, carrot than stick like pull-through preferences. We’re starting to see a lot of that.

And a lot of the problems are also, you know, with some of the more regional funds that have invested in these companies. As you all know, Rise of the Rest, we invest outside of Silicon Valley, Boston and New York. So, a lot of those geographies might be more susceptible to these conditions. And so, we’re seeing a lot of regional funds tapped out or they don’t have reserves for all of the companies that are now seeking to fundraise. And a lot of crossover hedge funds had also forayed into the VC market who have been particularly hit hard and, you know, are not willing to participate in these follow-on rounds.

And just my own perspective I think it, it does reflect that lack of relationship also with these companies when you have more regional VCs investing in companies in their own backyard. There's a stronger relationship there and more of a willingness to do follow-on offerings and support the companies that they're invested in, rather than it be more transactional.

So, you know, I think that's sort of what we're seeing around here. Obviously SPACs have decreased dramatically. We've, you know, most of the SPACs that we saw that were part of our portfolio company underperformed and then the market started shifting and the rules changes. And so, that's not as attractive of an option anymore.

So, we are certainly seeing a dramatically changed landscape now and we expect to continue seeing that.

MS. GARRETT: Thank you, Sapna.

Catherine?

MS. MOTT: Thank you.

I'm Catherine Mott from Blue Tree VC and Blue Tree Allied Angels in Pittsburgh, Pennsylvania. We've been serving the Midwest for about 20 years now with Blue Tree Allied Angels as a seed fund and now Blue Tree VC is serving Series A rounds.

I'm going to focus my comments on more micro rather than macro. Because of the 20 years we've seen varying market forces impact how, you know, how markets operate. And so, I'm thinking through what hasn't changed. Everybody is talking about what has changed. What hasn’t changed?

So, for the few minutes I want to talk about importance of private markets for small business growth, especially for the flyover region of the U.S. and the undeserved communities and minority population groups which already two of my colleagues have referred to.

We recognize the job growth in Capital clusters like New York and Boston and California, the success is obvious. There are elements for similar success in other areas of the United States. There are universities with excellent intellectual property. There are incubators and accelerators, talent, mentors, economic development agencies. But there is little capital to support the growth runway in the flyover region. Again, my two other colleagues have mentioned something similar.

Without local capital clusters entrepreneurs go where the capital is. The best jobs that could vest benefit local Louisville, Kentucky or Indianapolis or Kansas City or Pittsburgh will go to New York, Boston and California. That means jobs are exported from where they are needed most. I would encourage the Commission to continue to find ways to facilitate capital clusters in all parts of the United States with undeserved populations.

A couple of things I would like to focus on is the accredited investor definition. We’ve talked about expanding it. I think we should continue to look at that. One of the things I know that my colleagues here heard me speak about in the past is that earning 150K in Pittsburgh is like earning 275K in New York, Boston or California. And, as a matter of fact, when people talk to me about why should I move from California or New York to Pittsburgh, we kind of have a joke. They say what's the benefit of moving there, and our answer in Pittsburgh is usually discretionary income.

I would also like to encourage the Commission and the future Advisory Council to expand ways for capital pools and financial vehicles can grow locally. Where is a significant need for indigenous funds. It can't be supported by Techstars and angel investors and then there is a cliff. After that they don't get the money that they need for their runway.

So, I hope that we will continue to pursue the 99 investor rule and the 250 investor rule for equity funds. Right now that constrains the regional ability to raise funds to be able to support the growth of young companies.

And my final comment is I'd like to thank the SEC and all the folks at the SEC for the honor and the opportunity to have served several times on this committee. So, it's been the highlight of my career. Thank you.

MS. GARRETT: Thank you, Catherine.

Jason?

MR. SEATS: Hi, I’m Jason Seats; Chief Investment Officer at Techstars. We are an early stage venture investor investing very early stage in the U.S.

I’ll make some macro comments on my neck of the woods, venture Capital. The end of 2022 Q4, as Sapna mentioned, saw a real slowdown in venture funding activity. However, I would say just by nature venture capitalists in the start-ups and entrepreneurs that we backed were optimists. That’s how we’re wired. And so, the industry as a whole, while it’s absorbing market resets, you know, down rounds and lower valuations, et cetera, it is very much seeking a floor and a new base to build from.

And I think expectations, my expectation would be that we see that this year. And so, while overall the numbers may be down quarter over quarter and in Q4 it feels to me like, at least in venture capital, we’ll start to see some stabilization of the capital outflows.

Lot of dry powder is still available in funds and I would say, if anything, the slowdown is more in this corner of the market the absorption of the repricing of equity. And once that stabilizes I think the flows pick back up.

I think lots of great opening remarks here. I appreciate all of them and maybe a couple others that I’d like to react to. In particular, Commissioner Uyeda, I appreciate the skepticism on some of the, on some of the proposals in place. And I think one of the things that you mentioned that I'd love to underscore is the painting, the risk of painting with a broad brush and the fact that a $50 billion hedge fund is a very different beast to regulate versus a 50 or even $10 million venture fund.

And while the risk of fraud may be increasing because of ChatGPT or similar technologies, I think a think for the Commission to appreciate is the, is that perhaps the more effective enforcement is a better mechanism for counteracting fraud versus increasing regulation.

In particular, when increasing regulation has a disordinate sort of impact on small fund managers and emerging managers, particularly in the flyover states, particularly under-represented managers who are the pathway the capital is going to make it to the small businesses that this committee was formed to assist. Thank you.

MS. GARRETT: Thank you, Jason.

Sue?

MS. WASHER: Thank you, Carla.

For those of you who don't know me, my name is Sue Washer and I'm the former President and CEO of Applied Genetic Technologies which is a Florida based company involved in gene therapy and ophthalmology. And we recently sold our company in November of 2022.

So, I will say that, I will speak to my space of biotechnology, life sciences, diagnostics, med tech, you know, very specialized space for sure. And it’s been a really hard two years for the biotechnology industry. The whole indices in 2021 was down over 30 percent. It went down another 30 percent in 2022. And most people you talk to in investment banking and the VC world and the hedge fund world don’t really think that the confidence is going to come back in the biotechnology sector for at least another two years.

So, when you’re an entrepreneur in this kind of space that has huge capital needs, just really out-scales any other kind of business that you’re growing, it’s a very, very challenging environment right now. And I think it has to do with several different things. One is that the FDA which regulates all of the life sciences, there’s been a lot of changeover there. There’s been increased fuzziness around end points and clinical trial design. And also, I think biotechnology and life sciences in general gets very nervous and shaky when there’s talk about big healthcare reform.

And so, that level of uncertainty means that general investors are just not interested in investing in the biotech space. And where that comes into play is not at the very beginning. It’s very interesting. Years ago it used to be the first money was the hardest to get in biotech. Now it’s generally the easiest because there’s many, there’s a diversity of availability. So, you can get SBIR grants. You can get grants from patient advocacy groups. You can get local grants. You can get angel investors. There's just a huge number of people that are interested in that hot new idea. You can even get VC money if you just have a great scientist and a really cool idea.

So, then you're at, but that's, you know, that's a certain sum of money. Then you get into clinical trial design which is highly regulated. There's just no cutting corners. There's no way to do it inexpensively. It's a huge capital outlay. And then those diverse early stage funds don't have that money. And so, you have to go to the large VC funds and eventually you have to go public.

And something that worked really well in biotechnology many years ago was the JOBS Act. What that allowed to happen is earlier stage biotech companies to get into the public markets and get that huge amount of money, hundreds of millions of dollars, to even get through clinical development. And that's just not happening right now. The companies, if you don't have like your final set of data and you're going to file a BLA tomorrow, you're not getting the money. And sometimes you're not even getting the money when you have the data and are filing the BLA because of the uncertainty around healthcare reform and the FDA.

And I think that this is really an issue for the

United States and it goes back to competitiveness. Our biotechnology industry is not just in healthcare. It's in Ag, it's in industry, it's fueling innovation that's making us competitive. And, you know, we could go into a long discussion about it was the biotech industry that allowed vaccines and products to be developed for the pandemic.

So, I think there's lots of things we need to do in this middle area. You know, and even in the middle area you don't get any M&A happening because the big guys don't want to take that reg risk either. And so, I think there's very good funding on both ends in the biotech sector. It's the center area where we need to figure out a way to make it more diversity, more availability of funding, and more creative ways of funding.

And I do want to echo what Jason said about the Commissioner's comments, is that one of the reasons the JOBS Act worked is it loosened up regulations and reporting requirements for small companies. If you start on the small investors making reporting requirements so stringent, that's going to go in the opposite direction. And I would really strongly recommend that that's not the way to make diverse amounts of capital available especially in small areas like Catherine was talking about in the flyover areas.

So, I think that those are the kinds of things we really want a handle on. And the cost of capital, I think, as some people have mentioned is really going up because the investors that are willing to invest in that middle stage in biotech, they’re attaching all sorts of bells and whistles on their equity investment. They’re wanting royalty grades on revenue when you get to revenue stage. They’re wanting warrants that are just have egregious terms on them that basically mean they’re going to make their money no matter what and the original investors probably aren’t. They’re going to get diluted out.

So, I do think that there’s lots of things that we can do but I think diversity and rational regulation is a better way forward than, as Jason said, kind of one size fits all, for either companies or investors.

MS. GARRETT: Thank you, Sue.

Bailey?

MS. DEVRIES: Thank you so much for the opportunity to share some thoughts today. For a little bit of background, Bailey DeVries. I lead the Office of Investment and Innovation at the U.S. Small Business and Administration.

We are responsible for managing the small business investment company program which partners with private funds to provide financing to domestic small businesses. Last year the 300-plus funds that we partner with, they provided $8 billion worth of transaction financing. And since the program was founded in 1958 it has financed over $120 billion worth of transactions to small businesses.

But in addition to that I have the privilege of overseeing the small business innovation research and transfer programs across the 11 participating agencies in the Federal Government and sat down at the White House Interagency Policy Committee on scale-up technology as well as the Lab to Market Committee. So, I'll share that as a little bit of context around where I'm focused.

But I would like to set the stage to say that when I think about the challenges and some of the opportunities in 2023 in terms of capital formation for small businesses, I'd start by saying what are the outcomes that we are striving for? Some of these themes have been raised already but securing our national security, more equally distributed economic opportunity and growth and a stronger global posture, global competitiveness.

So, our small businesses; new small businesses, established small businesses are critical to successful outcomes in these areas. What we have seen within our office and discussed on the White House Interagency Policy Committees are issues around banks tightening their lending standards. At the same time the cost of capital for banks is going up quite significantly with the capital charge, high capital charges that they're facing for their private investments. So, they are in a difficult position.

So, that means that we have to think about the private markets more and how they can serve the needs of small businesses. We are also seeing more new small businesses created than ever before. So, this is wonderful news, at the same time it presents many challenges. In 2021 we saw a massive influx of early stage small businesses being financed by venture high valuations. These businesses are growing, they're maturing, they're scaling up; however, the cost of capital is higher and we have grave concerns about their ability to raise a future round of capital.

Additionally, there has been a massive increase in terms of Main Street small businesses, wonderful news, right? But a big challenge is that these businesses without revenue history are not in a position often to get loans from banks. So, what do we do? What do we do?

I think we have a really exciting conversation in front of us today around revenue-based financing because we probably have to start thinking a little bit differently and thinking beyond traditional equity investment strategies and debt strategies and thinking about flexible capital solutions that are well aligned to the needs of the entrepreneurs that are starting these businesses. Alignment is everything.

And if we can come up with solutions and have regulatory support for new flexible investment solutions that need these businesses where they are, I think we will be able to do a lot of good. And not just for the Main Street small businesses but, as Sue spoke about, for some of these more capital intensive businesses where cost of servicing debt can become untenable when they are also trying to grow.

At the same time we're in an environment where with rising interest rates we need to find a way to compensate investors for the risk that they are taking in small businesses, particularly in start-ups and scale-ups.

So, I will close on those thoughts and then also just say that I echo Sue's sentiments around the importance of diversification of the financing options that are available both in terms of the investment strategies, the geographic location and flexibility about the capital. It is necessary. Thank you.

MS. GARRETT: Thank you, Bailey.

Greg?

MR. DEAN: Hi, I'm Greg Dean with FINRA and we really appreciate the Commission's ability to have FINRA participate in this advisory committee. We think it's so important both for the capital formation of the small entities in our nation, but at well as to helping the small broker/dealer community with this. FINRA remains committed to working with the SEC and others, the stakeholders, in improving capital formation and access to capital for small entities.

We have, through these past four year, taken the recommendations back and looked at our rules and made a number of revisions both through the broker/dealer ability as well as how we oversee these particular areas. In addition, our capital acquisition broker who has a special rule set set-up for a subset of broker/dealers just for capital formation capabilities. We continue to look for guidance on how we can improve that to an open door policy for stakeholders to come to us.

Also, with regard to this we are looking at the investors. It was brought up earlier that do we know who the investors are and how they're investing. And that is the one thing the FINRA foundation has taken in the past few years in great strides putting that research out.

In December, just two months ago, we released the study, Investors in the United States, the Changing Landscape. And this is part of our national financial capability study. And what we have seen through the FINRA foundation is that there are a lot of younger investors investing in the markets. They're using different means to access the markets including self-directed broker/dealers. And there's also some storm clouds that are brewing on the sides as well. Where they're getting their information to invest varies from investor to investor. A lot are using social media and other avenues that may not have the best or most accurate information.

So, I think as we move forward there's going to be a lot more understanding of who the investors are, how they're investing and how do you reach those particular investors. So, I know for this particular national financial capability study we're breaking it out into smaller studies looking at demographics and looking how those different demographics, how they access information, how they invest and what type of investments they're looking for.

FINRA also is changing some of the rules to help the broker/dealers. We recently worked with the SEC on updating out syndicate rules, underwriting rules for corporate debt, which is really important because this helps the broker/dealers get the financing faster through these corporate syndicates, which will then help them help more small entities get to the capital.

And so, thank you, again, to the SEC and thank you for everybody participating here. It's been, you know, listening to all the expertise and advice and guidance and recommendations you have has been amazing over these past four years. So, thank you for all of that work and thanks for allowing us to participate.

MS. GARRETT: Thank you very much, Greg.

Marc?

MR. SHARMA: Thank you Carla and I’d like to thank you and Jeff Solomon for your excellent leadership of the committee over the past four years, great job.

So, my name is Marc Sharma and I am the delegate to the committee from the SEC’s Office of the Investor Advocate. So, I am a non-voting member and as an SEC staffer I will desist from sharing my own personal views about capital formation. But what I can share with you is on March 2nd the investor, the SEC’s Investor Advisory Committee will be holding a public meeting and will feature a panel on private and public markets that you may be interested in viewing.

But finally, I’d just like to thank the committee members for their service, for their valuable input. I’ve been taking copious notes this morning as I do in every meeting, and I will take your input back to the Investor Advocate for consideration to help us think through policy and help inform our advocacy efforts. And I’d just like to thank you all and thank the staff of the Office of the Small Business Advocate. So, back to you, Carla. Thank you, very much.

MR. SOLOMON: Thanks, everybody, for your comments and it’s really been helpful. I think Carla and I are just going to wrap up pretty quickly, and we’ll move on to the next.

I think just what we’ve seen and we’ve heard here is the difficulty and the challenges we’re facing. I think it’s probably worth mentioning that a lot of the challenges we’re facing have not been as a result of regulation. And if you look at the macroeconomic environment, you look at free money, free money pretty much always brings about rampant speculation.

It’s what happened at the end of the 1990's, after the long-term capital crisis. We went to free money and we had rampant speculation, and that ended in 2000, and that wasn’t good.

We just had free money for the last two years, for a lot of good reasons, and that led to rampant speculation, crypto, Sara, you’re 100 percent right. A lot of small companies got financed that should not have gotten financed. A lot of things happened in the public market that should not have happened.

That’s what happens when you have free money. We no longer have free money, valuations have been reset, and investors have gotten hurt. None of that has anything to do with regulation.

I think when we think about the ways to protect investors, we should ask ourselves the questions going forward if the things we’re doing would have prevented that from happening, or is that just going to happen anyway, because that's what happens when you have free money?

And so, it's really, really critical. There are some great proposals that have been made to use regulation intelligently and targeted to protect investors. Particularly around some of the risks that we continue to see that permeate.

Let's be super careful about over-regulating, like sort of what happened in the end of the 2000 tech crash, because it has long-term economic impact on America's ability to grow itself in critical industries. Capital-intensive industries require capital, and they require investors to make those investments.

And so, as we emerge from this period of time, let's try to be a little bit more targeted with regulation that really aims at solving problems for investor protection, for sure. Because you can't have investments without investor protection, let's make sure we're not over-regulating to the point where we're excluding investors from actually being able to participate in this valuable ecosystem that will provide growth.

And I think that's kind of what I heard from everybody in sum total. I don't want to speak for everybody, but as I was thinking about this, just listening to each and every one of you, that's what I came away with.

MS. GARRETT: I absolutely

agree, and thank you, Jeff, for that summary. I think that was a good way to end our remarks. I appreciate everybody going around and speaking. I think we had some very valuable and interesting observations today.

So, we'll move on to our first agenda topic, which is revenue-based financing and other alternatives to traditional bank and VC funding for small and mid-sized companies that have not gone public.

We will have about 45 minutes to discuss this topic, and to offer a framework for our discussion, the SEC Small Business Advocacy team's annual report, which each of us have in front of us, has information on how capital is being raised across the country.

For those watching online, the annual report can be found on the Small Business Advocacy team's website. I'd like to point out at least one data point from the annual report that I think is particularly relevant for this discussion.

On page 25 of the report, it notes that 52 percent of small and emerging businesses seek external financing. And, of those, only six percent of those companies seek equity investment. So, in 2021, fewer small businesses than in prior years received all of their requested funding or met their financing needs, underscoring the ongoing need for more funding alternative for small businesses.

Keeping these challenges in mind, today the committee will explore alternatives to traditional financing models, how these financing alternatives differ from traditional bank and VC financing and various factors that make these alternatives attractive to investors and founders alike.

And we have two speakers that we are happy to welcome with us today on this topic. First, we welcome Melissa Withers, the Managing Partner and Founder at RevUp Capital. Previously, Melissa was a managing director of a pre-seed fund that invested in a number of small companies.

Frustrated by the constraints of the equity-only model, Melissa co-founded RevUp Capital, one of the first revenue-based funds for early stage companies. Through RevUp, she’s invested in over 40 small companies. Melissa is also the founder of Operation Athena, an investment resource for female founders and black and brown entrepreneurs.

With a background in live sciences, Melissa started her career at Whitehead Institute for Biomedical Research at MIT. Welcome, Melissa.

We also have with us today Damien Dwin. Damien is the Founder and CEO of Lafayette Square, an impact investment platform that aims to create investment opportunities in underserved markets. Lafayette Square invests across asset classes and seeks to provide risk-adjusted returns to investors, while positively supporting people and communities.

Prior to Lafayette Square, Damien served as a co-founder and co-CEO of Brightwood Capital Advisors, and he began his career at Goldman Sachs. Welcome, Damien.

Melissa and Damien, we appreciate each of you taking the time to be with us today, and your willingness to share your expertise and perspectives with us. I will turn it to Melissa first.

MS. WITHERS: I was feeling quite relaxed until you all gave your opening remarks. So, I want to thank you not at all for demonstrating how you are all so incredibly capable and competent that the bar is now quite high for me to say something meaningful that may, in any small way, influence your thinking about this. So, thanks for that.

It’s a really meaningful opportunity to be here today to talk with you about innovating the capital tool kit. Like you, I want more entrepreneurs to be successful in building their businesses. And I’ve been working as a professional investor now for about a decade, and prior to that I was a founder myself.

And I also experience, first hand, a lot of the bias and inequities that are endemic in the venture system. And had I not experienced that, I probably wouldn’t be here today. As they say, necessity is the mother of invention.

And so, for me, embarking on an effort to innovate the capital tool kit wasn’t so much a choice, as it was a necessity to accomplish many of the goals that I wanted to accomplish both as a founder and now as an investor.

I’ve worked across a few different models, and I’ve invested now into more than 100 companies. And so, find those 100 companies, I’ve probably talked to or looked at thousands of companies.

And I care very deeply about the founders that I’ve mentored, invested into and worked with. And I really, truly want to thank you, on their behalf, for the work that you’re doing to try to support them on their journey. They’re out there today, while we are in here, building their companies.

And I was so shocked and surprised to hear how authentic and genuine your attitudes were towards those founders and those entrepreneurs. And so, on behalf of all of them, thank you for the work that you do.

I have a few notes but, really, I know we have such a sliver of time, so I really hope that someone will interrupt or ask questions if there’s something that’s more interesting to you and your work.

I’m thrilled to be here today to talk to you about revenue-based investing, but I have to open with a caveat which is the worst way to open remarks, is with a giant caveat. But it’s very important to note that revenue-based funding, as it exists today, is a very diverse category of capital tools and products.

And I have less in common with other investors who use the words RBF, but I do sometimes with boutique equity funds. And I, in now way, represent the entire spectrum of products that are out there today.

So, think of this as like an appetizer course. There's a lot more on the menu that we can't and won't cover today, but we'll try to find some themes that will help you understand it better. But, in essence, my model is but one flavor of what's become a veritable smorgasbord of things calling itself revenue-based funding.

So, I am the Co-founder and Managing Partner of a fund called RevUp Capital. And since 2016, my partners and I have been using a non-equity, revenue-based model to invest into a really exciting class of companies.

Good news, we've produced excellent outcomes for investors, but better news, in the context of today's conversation, I am really proud of the founders that we've been able to support.

Since 2016, more than 60 percent of the companies that we've invested into have been run by a woman or a person of color. And those that weren't are run by founders who are building their businesses without the benefits of networks of privilege.

From many of you, I learned some new words today about fly-over geography; I like that. For me, it's usually just outside major metros. So, most of my investments are; I'm from Boston, most of my investments are not in cities like Boston. They're elsewhere.

So, let's start from the top. So, what is a non-equity revenue-based funding model? In its purest form, and this is perhaps what most of us have in common, those who call ourselves revenue-based funders; rather than take an equity ownership in a company, we use what's called a revenue contract.

Wherein companies will return value to the fund through their revenue growth over time. Again, that can mean a million things. But, effectively, what it means is that we can produce value without exits. It means that if companies grow and there is growth potential, I can effectively invest into that company without having to have a sole dependency on exits to generate returns.

In that sense, it opens, already opens up the spectrum of companies that I can invest into comfortably. Because I don't need to be confident that they will, ultimately, produce the kind of exits that investors look for in those kinds of models.

So, as you mentioned in my very long bio; thank you, Carla, I didn't start here, I ended up here. I started out as an equity investor, well, I started out as a founder. I also had jobs; that’s a thing you used to have to do. And then, ultimately, found my way to revenue-based investment.

Because when I was managing a seed-stage portfolio, I personally, professionally did that 90, I did 90 companies. Became extremely frustrated by the constraints of the equity-only system. This idea that the only way to produce value was through liquidation events was farcical.

I mean, it was also creating a lot of bad behaviors in the industry. So, I was saying yes to, saying no to companies that had products and services that I knew the world wanted and needed that market traction.

And I was saying, and saying no to those companies, but saying yes to companies that had no product yet, but they had a slide that showed a hockey stick for growth. And that they were one-day going to be a runaway unicorn success. And so, in some ways when we created RevUp it was with that intention.

It was to break free from the dependency on exits as the sole mechanisms by which could create value. And, in that sense, I heard somebody flip it around today and talked about the real unicorns are, you know, are not what we think of as unicorns, but the myopic obsession with unicorns still exists today.

And that manifests in the belief that the only companies worth investing into are those that are going to become gargantuan, shoot the moon, really like out there wins. Where, in fact, so much economic and social value is predicated on a class of companies to the left of that, and that’s where I spend my time.

So, that’s what we did, and that’s what we created. And we knew that we could create good financial outcomes for ourselves, for our investors, but also reach deep into communities and reach founders that were really prohibitively hard to access through venture.

I couldn’t, in good conscience, invest in some of these companies because I knew that the downstream investors wouldn’t be there to support them, and I knew that the exits wouldn’t happen.

And so then, like most other venture investors, I would just be burning money in a barrel, which is what venture is really good at, but fast forward to today. So, what are some of the benefits of revenue-based funding for founders? And I’ll get to the end and I will also tell you that this is not silver bullet. All capital has its cost, and there are all kinds of ways that revenue-based investing can be used to cause harm.

So, again, I think it’s just really important that the, I think the idea here is to expand the capital tool kit, not to vilify one model and elevate another into hero status.

Of course, though, I do want to be the hero, so it is my intent to leave you with a tiny suspicion that my model is better than that model.

So, one of the benefits for my kind of RBF investing for founders and, again, my kind; we're not transactional. We're long-term investors. We're with our companies for four to six years.

There's a whole different class of RBF out there that looks more like debt, is shorter term; very useful, very important. But just to orient you, I'm talking about my flavor, which is sort of longer term, more strategic investing.

So, one of the primary benefits is not debt. Most people confuse revenue-based investing, which is an obligation, with debt. But it acts and behaves differently inside the company, on the balance sheet. But also the risk to the founders as individuals are quite different. The risk to the investors are also different, because it's not securitized and it's not debt.

But because there are no personal guarantees or no securitization, it allows founders who are not eligible for traditional debt, which is most founders; unless you want to put your house up, which you generally shouldn't do because start-ups were born to die. So, you will probably lose your house if you do that.

But it also gives access to founders who maybe, if they looked or acted different or lived in a different geography, could access debt. So, it's not debt which is what makes it very useful to a lot of the founders that I invest into.

I think, also unlike debt, in my model, again, it's unstructured and it's tied to actual revenue. So, one of the downsides to structured debt is whether you have a good month or not, you know, whatever your payment terms are, you're probably going to have a bill due at the end of the month.

In my flavor of revenue-based funding, the investment is tied to the company's actual revenue performance. So, if a company has a bad quarter, I have a bad quarter. So, pros and cons to that; if you have an awesome quarter, I have an awesome quarter.

And therefore, too, your obligation to service that obligation would be higher. But for people operating businesses, it means that the obligation kind of rides with you so that you don't get to the end of a time period and, suddenly, oh, we have to service debt that you no longer have the cashflow to do. And so, for a lot of founders, it's a more comfortable way to think about the obligation.

And then most importantly for a lot of founders, it's non-dilutive, right? It doesn't erode your ownership stake, and it also doesn't put me, as the investor, in a position of piloting your business.

So, we don't take board seats, and we, ultimately you know, are not motivated to continue to dilute your ownership in order to increase the chances that we make more money on the exit, all right? So, for a lot of founds, I think, collectively those are the things that they're interested in.

So, what are some of the benefits on the investor side? I think one of the primary benefits for my LPs and many LPs is it gives you access to an asset class that very difficult to access through traditional venture.

So, if you want to invest into women-led companies, for example, good luck doing it through venture. Such a tiny fraction of those dollars go to women-led companies that you have to work really hard to find a venture product that's going to give you access to that asset class.

If you like to invest in secondary geographies; I have investment in large cities like Atlanta, but some of my most fantastic and meaningful and productive investments have been in places like Pittsburgh, the Raleigh-Durham area, right, Nashville. Places where, you know, you're just not going to access those companies through traditional venture.

I also think, while my model is still high risk by many investment standards, it is, has a different risk profile than the all-or-nothing world of venture.

When I was managing an equity fund, I knew that if I invest into 100 companies, my expectation is that 80 of them would do nothing, 20 of them would do something, and maybe five of them would perform in a way would allow me to make a modicum of money.

And the model in most RBF, the opposite is true. We're looking for most companies to do about what they set out to do. And so, for the investors, they're trading off the sort of 10X outcome for a more moderate risk profile, which still gives them access to a pretty exciting asset class.

And then, depending on the model, there are other advantages for investors around liquidity. So, because, I mean, I often used to say waiting for exits was like waiting for Godot. Like it's like watching paint dry. I mean, people used to talk about exits taking three years. Then it was five years. Then it was seven years.

When I, I just had an equity investment that my son was in second grade when I made that investment. He drove himself to school yesterday, and I'm still waiting for that investment to liquidate. So, for some investors, it depends on the model. There can be a quick return on capital, and that just gives you more optionality.

And I'll give you a couple examples of a few companies that we've supported over the years that I think bring all of this together. I was informed, gently, to not use the names of the company for fear that it could infect; infect, that’s an awful Freudian insert of terms there but, so I’m going to generically describe them to you.

One company that we invested into in 2022 was a company based in Atlanta that’s called a 3PL; it’s essentially distribution and fulfillment terms for e-commerce brands. This business is the only black-owned 3PL and, in particular, they service women and black-owned e-commerce brands that really don’t get the kind of service they needs from general 3PL, right?

They’re just, they’re under-capitalized. They don’t, they can’t afford to, they’re not starting at the scale. And so, this company, not only is that not an attractive industry from a venture, but these two women; it’s the only black women-owned 3PL in the United States. Suffice it to say they did not, like, have access to a known network of venture capital providers.

MR. SOLOMON: Can you just tell people 3PL is third-party logistics.

MS. WITHERS: Yes.

MR. SOLOMON: Like, give them the name of the bigger companies that actually do third-party logistics.

MS. WITHERS: I don’t know the names of those companies.

MR. SOLOMON: FedEx does third-party logistics.

MS. WITHERS: Oh no, no, not --

MR. SOLOMON: UPS does third-party logistics.

MS. WITHERS: -- I’m not, no not, not like that. These are, think of warehouse fulfillment; organizations that fulfill like ship and pack. So, not the, not like the FedEx, but --

MR. SOLOMON: So, one step before, let’s say, Amazon, right?

MS. WITHERS: Yeah.

MR. SOLOMON: So, if you’re a seller on Amazon, you may need to have somebody pick-and-pack for you to get it to an Amazon warehouse?

MS. WITHERS: The --

MR. SOLOMON: Okay, got it.

MS. WITHERS: Another company that I, in our 2022 fund is based on Philadelphia. They create a very small non-electrical indicator that you can stick, it’s just a sticker, on any kind of helmet or safety apparatus. And if the wearer receives an impact sufficient enough to cause concussion, that little indicator will turn red; hence the trade mark if it’s red, check your head.

An amazing company led by first-generation Cuban-American founder, and it’s growing. It’s an amazing company. Again, really difficult for venture because it’s not software, it’s hardware, it’s one and done. But for us was a tremendous fit, and also in this empire that I’m building one female founder at a time, a pretty good fit, culturally, for us.

And then another really interesting company is here in the DC area. They do a software product that offers literacy competitions for families and communities to help those groups and organizations promote literacy at a community level.

They provide services to thousands of families each year. But they are not that attractive to venture investors because ed tech isn’t, it’s not that sexy because it doesn’t make that much money. They were a very productive investment for us, but they also, they really provide something that’s truly, truly effective.

MR. SOLOMON: Melissa, I just want to, before you wrap, I just want; can you cover two things?

MS. WITHERS: Yeah.

MR. SOLOMON: First of all, how are you sourcing, and how do those companies find you. And then, can you just talk about like where do you get your capital from that it seems to have an indeterminate timeframe?

That’s an awesome thing, so maybe there’s ways we can learn about where those pools of capital actually exist.

MS. WITHERS: Okay, so I’ll start with the second question first. So, I’m on my seventh fund. The vast majority of investors in our fund are high-net worth individuals that are attracted to these parts of the model.

We raise annual funds, relatively modest-size funds. This year’s fund is only a $6 million fund, but we deploy those funds in a single year, and then raise an additional fund. But the vast majority of investors are just individuals that are --

MR. SOLOMON: Accredited investors under Reg D?

MS. WITHERS: Yes.

MR. SOLOMON: Okay.

MS. WITHERS: Yeah, and it’s actually a giant headache to make sure that every investor has attestation to make sure that they are accredited. So, it’s something we do take quite seriously.

MR. SOLOMON: So, if you could open that up; you’re on your sixth fund, and you’ve had good performance. If you could open that up more broadly, would you take more money, or is that sort of the idea amount?

MS. WITHERS: No, I really don’t, I mean, I think in my world it, the standard for an accredited investor is about right. Like I really don't want to put anyone's rent money at risk, right?

So, I'm confident that my investors, that if I lost all their money, which I could, by the way; I have not, historically, but I could, no child will go hungry. No kid won't get to go back to college in the fall. No, in my world I think I'm comfortable requiring my individual investors to be accredited, and to be able to sustain the risks associated with these kinds of investments.

MR. SOLOMON: Got it.

MS. GARRETT: And what is maybe an average amount of investment?

MS. WITHERS: Yeah, we put between $350,000 and $500,000 into a company. So, we're part of a capital staff, usually. So, we're not enough to change the game, but we can play a pretty important role either bridging a company between maybe how it got started and where it wants to go.

In some cases we are a pre-cursor to an equity round wherein the founders can get more optionality out of it. And in many cases, we had a company in Raleigh, North Carolina that was run by a black founder who got no love from his community, even though he should have, right?

Everything about that company made sense from a venture perspective. But fast forward, that company was sold last year to the London Stock Exchange for $200 million, and he has only about $1 million of equity at play. So, they made 20 millionaires inside that company on the day that the transaction happened.

And we were able to invest in that company at a time when it's not obvious that they would have been able to continue on without that relatively small infusion of capital. So, we are kind of flexible in where we sit.

Now, there are downsides to what I do, as well. And I want to really, in fairness to other capital providers, you know, it's not for everybody; it's not a silver bullet. There are risks, all capital has its cost. And we are, we do a terrible job, collectively, educating founders on how to be capable capital navigators of their own business.

I spend a lot of my time, outside of my formal work, working on capital education for early-stage founders so that they can navigate these tools. And the market is flooding with these tools. And you can get yourself into a lot of trouble if you don't know what you're doing.

The devil is in the details, and it's in the fine print. And if you don't know what you're signing up for, you could get yourself in a lot of trouble. And even in my model, sometimes it doesn't fit. If you have underlying unit economics that don't work, then it doesn't work.

So, I do think that it's really about thinking about the capital tool kit, freeing ourselves from this notion that venture is going to provide everything for all. And start to see our ways into matching investors with, who also, and I could, obviously, have a lot to say; I could go on and on.

But there is a new generation of investors that care about different things, and have new values. And they are attracted to alternative models. So, whether we like it or not, these investors are coming, and it’s our opportunity to match those investors with the companies out there who could benefit from their capital.

MR. SOLOMON: Melissa, this is very full. Is there a term of your investment? And what if you or the company decide you’re not a match long-term? How do you deal with that?

MS. WITHERS: Well, we can’t, once we write a deal, you can’t really walk away from it. Most of our deals are between five and seven years. So, again, it’s very, it’s a, it’s a long-term deal.

So, companies are returning a very small percent or revenue; four to six percent, to a fixed multiple, which can take a long time, even if you’re growing relatively quickly. So, we are different than some of the transactional RBF providers, like Clear Bank or Leiter Capital that are out there.

MS. GARRETT: And just before we

ask more questions of Melissa, because I think we probably all have a lot of questions for Melissa, we would like to hear from Damien. And then we can ask questions to both of them.

Damien?

MR. DWIN: Good afternoon. Thank you for the opportunity. My name's Damien Dwin; I'm Founder and CEO of Lafayette Square. I'd like to transition, if we could, to some data substantiating remarks that have been made here in the room.

I'll make three points. The first is there is a benefits crisis in the United States. American workers are living check-to-check, and it has business risk implications for the entire system. Capital customers, everyone is at risk because of this benefits crisis.

The second point I'll make, and then we'll go through the slides is that it's obvious there's a capital crisis. But I want to specify what that looks like, particularly for middle-market companies where today the secured overnight financing rate, SOFR, which has replaced LIBOR, in three months is at 4.6 percent.

I repeat, at 4.6 percent, if you add 500 or 700 or 900 basis points, the debt for companies with EBITDA of $10 million to $100 million gets to the 10 to 13 percent area to borrow cash. If an entrepreneur needs to roll her debt forward, she is in the awkward position of having to pay, effectively, double what would have been paid 12 or 18 months ago.

The duality of this benefits crisis infecting the labor pool in American business, combined with the excessively high cost of capital, I will point out, comes with a third factor; place. Geography has been mentioned throughout today's comments.

And the intersectionality of geography, cost of capital and employee benefits is something I would encourage us to explore. And so, I'll take us through four slides in rapid succession. There are notes for everyone live streaming this and, obviously, those in the room can enjoy the benefits of seeing the footnotes up close.

But number one, it's about the worker. You don't have companies without employees. And employees today are living paycheck-to-paycheck. I will point out over 40 percent of Americans don't have $500 of liquidity for an emergency.

This is the labor pool that drives American industry. To quantify, this is 50 million workers spanning 300,000 companies. This is the heartbeat of the United States.

To move forward with the slides, let's go back here; you see that a third of American businesses are headquartered in geographies which we know are statistically overlooked and underserved. Our census bureau rolls this data forward every 10 years. We have great detail on who is able to borrow money, and it does not line up with the geographic and economic dispersion of wealth in this country.

So, it’s interesting where does capital flow, and what’s happening to the people that actually do work in these businesses? If we could advance to the next slide, please.

Here we quantified the point made earlier that, in aggregate, the U.S. middle market is on par with Japan. It’s the third largest economy in the world. It is massive. And those 300,000 companies are employing, as I noted before, over 50 million people, but these aren’t start-ups; these companies are, on average, 30 years old.

It’s a lot of tax dollars. It’s a lot of tuition. It’s a lot of healthcare. And it’s funded by this ecosystem that relies on banks and non-banks to fund their activities. They found themselves in this moment, following activity by the Fed, where not only is liquidity tight, but they also have a labor shortage because they’re struggling to keep butts in seats in their enterprise.

We’ll conclude with this slide which, again, give you the sense of what America looks like based on the concentration of low-moderate income people. The definition of LMI is 80 percent of area median income or less.

And you'll notice the smile from the Carolinas through the Gulf Coast over to California has a higher concentration of low-moderate income people. It also happens to be where you see this great migration of business from California and New York and high-tech states to these lower-tax places.

It will not surprise folks in the room and on the live stream that the availability of healthcare goes down as you move into these regions. The prevalence of payday lending increases as you move into these regions.

And enterprise cannot turn a blind eye to what's happening to human beings working in these businesses while dealing, as I pointed out earlier, with these challenges on how to maintain access to non-diluted bank capital.

So, with that, I'd love to take the screen down, and give you a sensibility of where we are, as an industry, in the U.S. middle market. This is a trillion-dollar asset class which really expands public and private fund structures.

SEC regulates most of it, but not all of it. And the primary solution offered to entrepreneurs is five-year floating rate debt. Transaction sizes of $50 million to $200 million is the sweet spot.

But you're seeing transaction sizes today as large as $1 billion, and there are some publicly traded managers who are actively pursuing $5 billion transactions, again, as unregulated entities that are not banks.

This is interesting because if you are a small, private company seeking $50 or $100 million of capital to roll your debt forward, you have audited financials, your business is growing. You’re looking at a borrowing cost of about 10 percent. That’s today.

As you’re looking to borrow the money at 10 percent, you’re looking at a workforce which is less stable than it’s been at any point in the last 10 years. This is a really challenging moment for entrepreneurs.

And of course, you’re seeing in the public filings of some of the assets managers, folks are earning, after fees, double-digit net returns, and marketing themselves to take in more capital to do this style of lending. Whether it is distressed investing, performing credit investing or hybrids in the mezzanine space, where you’re a combination of debt and equity.

So, I am an optimist. I believe we have capital markets that know how to heal. I believe we have regulatory frameworks in place that create opportunity, not challenge, for investors, but this is going to take time to work through.

And I believe there is a disconnect between the harsh reality of the benefits crisis that’s happening with labor, the cost of capital that is impacting entrepreneurs and, finally, the role that geography plays in how this works.

Because, you know, being a D.C. kid who grew up here in the area, I’m a proud Georgetown alum, and I would say the cost of capital in Georgetown is lower than it is in Anacostia.

This is an a meritocracy. Capital is not efficient. And we have a role to play, as people with power and influence, to think deeper about the interplay of these three factors; employee benefits, cost of capital for business and place.

With that, again, thank you so much for the opportunity.

MS. GARRETT: Thank you, Damien. I appreciate that.

I’m going to do a quick aside because I happen to own and run a small business that is based in Oklahoma. It’s been a family business for over 60 years. We employ people that have been there for 20 to 30 years.

We provide healthcare benefits to these people. And, but we need salespeople around the country, and we’ve having a very, very hard time finding people, salespeople. So, you know, we’re hitting a lot of the points that you said.

Currently, in the process of re-doing our line of credit with a new interest rate and I can tell you it’s a challenging time for a small business in Oklahoma, but we employ a lot of people, and I want the company to keep going.

And these people rely on our jobs because if we, this is a very small town in Oklahoma. If I was not employing them, I don’t know who would. So, anyway, I’ll open it up for other questions now.

MR. BAIRD: I just had a quick clarifying question for Damien on the migration of employers to the southeast and southwest. Is that middle-market employers or larger employees, or both?

MR. DWIN: Both, it’s both.

MR. SOLOMON: Damien, your firm announced that you had done some things with the SBA, the SBIC; can you just walk through that a little bit, and how you think that will help to accelerate your business?

MR. DWIN: So, I’m a proud alum of the Small Business Investment Company Program. SBA put me in business about 11 years ago. What it means to be an SBIC license holder is that you’ve been vetted by the Small Business Administration with really one of its flagship programs.

Affording you access to capital, which you would then make available to small, medium-size businesses under strict definitions that have been set by Congress and SBA.

It means you are genuinely committed to creating jobs in the middle-market, particularly the lower-middle market, based on the net income and net worth of the businesses that you finance.

The program is interesting. It’s been around since the 1950's. There are, in any given year, probably 20 to 30 new people who get licenses. Some are coming back for repeat licenses. But it allows you to borrow money for 10 years, fixed, priced off of the 10-year note. And you can repay the debt whenever you need.

The advance rate is 67 percent. Said differently, you can borrow $2 for every dollar of equity raised from the private markets. So, in effect, this is a public private partnership.

I have a track record of raising equity from private markets, and then combining that with leverage from SBA, and putting that money into small and medium-size business.

But the most exciting thing is in this moment, given the statistics I shared earlier, SBA financing, effectively, is at SOFR-minus. But this is, this is very profound because of the way the yield curve is shaped today.

You have an inverted yield curve, and you have a dynamic where if you are partnered with SBA, you can actually borrow on better terms than banks can borrow from each other.

The question becomes what does one do with that power. What moral and ethical obligation does one have to use that money wisely to create jobs? Classically, by providing first lien senior secured debt to growing businesses.

So, these are, again, loans; in my case with covenants, to enterprises that are generating EBITDA $10 million all the way up to $50 million or more.

In revenue terms, you could think about this as SBA having a longitudinal partnership with companies with less than $1 billion of revenue would like capital that, for whatever reason, isn’t available from commercial banks.

And there’s a lot that we have not discussed today about the state of the banking system in the U.S., and the incentives for commercial banks to play their traditional role in this space; something that’s just not happening.

MR. SOLOMON: Or lack thereof; that lack of incentives for them to play their -- let me ask you this.

Where are you finding your equity bed? So, you know, I think to be, you know, I don’t want to skirt over that. We talked a little bit of Melissa; she’s high-net worth individual.

Like where, when you say I’ve got a track record of raising equity that sort of, that one of the three, you know, one piece of equity and two parts of debt that you do; where are you going for that? And what structures are you using?

MR. DWIN: So, there’s six sources of equity that can support an asset manager like an SBIC or someone in the private credit space. Of course, we’ve talked about retail investors, so that’s one channel. Banks are another channel, particularly banks who receive CRA credit who are investing in funds.

A third would be silent wealth funds, which have been flowing into private credit in a meaningful way. Then you have some conspicuous parties like insurance companies. Endowments and foundations. And finally, pension funds.

Those are the six ways that capital flows in the United States for private credit, and I spend a lot of time thinking about all six channels. The requirements to do business with each of the six are different.

Some have gatekeepers like consultants. Others require having a long track record and personal relationships with folks who control platforms. But, in my experience, if you want a source leverage an SBA is one source of leverage.

It sits along places like Japanese institutions who, because of their low cost of capital and their life force securitizations and structured products will come and provide debt.

European banks, obviously, the money center banks in the United States, there’s an ecosystem of leverage providers that have different requirements. That leverage gets matched with equity which, by and large, comes from one of the six channels I mentioned. And those channels are not flowing with the same volume and velocity.

Banks are going through challenges today. Retail investors just lost a lot of money. They're going through challenges, but there's a migration to private credit as an asset class because of these high returns that people are earning today.

There's commentary you could give on the damage to foundations who, classically, have shied away from credit because they really like venture, and now they don't like it as much because of what happened in the last 12 months.

So, it's interesting; I analogize this period to the 1970's. I believe this is a period of malaise, high rates, equity markets which are capped, and commodity volatility and geopolitics that distract both our politicians and our business leaders.

The question becomes how do we get to 1980, and see interest rates go down and have a policy support the turnaround? And I would tell you I just don't see it in the next 24 to 36 months.

But I do, again, with a sense of optimism, see clarity and consistency from some of our institutions. And this speaks to the power of institutions, like SBA and it's

SBIC program, which is open for business in good times and bad. And we’re going to find ourselves heavily reliant upon institutions, in my estimation, during this period of hardship for American enterprise.

I also will say I don’t believe Washington, D.C. should dictate how we close the benefits gap, the labor. We’re at a period of crisis. Workers need more benefits. They’re not getting what they need from their retirements or their healthcare benefits.

It would be a mistake if those decisions were made on the Hill. I think entrepreneurs leading these 300,000 companies, employing 50 million people, will become more thoughtful and strategic about how they solve this.

And I hope there’s encouragement from the capital markets to provide incentives to get there faster. I think a pre-requisite for those incentives to flow is transparency. We need data validating and explaining why it is a risk mitigant to have a safer, more stable labor pool. And if that can drive the cost of capital lower, that would be very exciting.

MS. DEVRIES: I’d like, actually, just to build upon some of the things you shared Damien. It might be helpful for the group just to share some data points. Because the private capital is so critical to SBA being able to play its role as a supplier to help crowd in more private capital and get money to these businesses.

Over 70 percent of the private capital that goes to SBICs today comes from banks, and that is very concentrated. And so, it’s worth noting that many of the challenges that Damien brought up the banks are facing today presents almost an existential threat to the program.

Because if they are not funding SBICs, then SBICs have to look for capital elsewhere, and there’s other restrictions on that today. And I’ll illuminate one of them, which actually ties into, Melissa, some things that you were talking about, as well.

Which is that Federal funding, directly or indirectly, cannot be used by an SBIC license fund as leverage for capital. So, we can’t provide a match against it. The fund can receive it, but we can’t match it.

That’s interesting right now given the fact that Treasury and the State Small Business Credit Initiative, the SSBCI, just, what is it, $8 trillion of the $10 trillion has gone out to the states and been allocated, and they are working with other program managers or funds to deploy that capital in the form of equity and debt to small businesses. So, there’s a misalignment there, given this restriction.

Furthermore, several of the states have actually been asking whether the SSBCI funding can be used for revenue-based financing models, and Treasury initially was very quiet on the topic. They didn’t address it, specifically, but recently has provided guidance to the states to say that no, it cannot because it’s not debtor equity.

So, I would just lift up the thought there to say should it be classified as debt? It’s a different type of debt instrument. From an SBA perspective, we are considering it to be a debt instrument, which fits within our framework and then opens up a flexibility for funds to have revenue-based financing models.

But we need this type of financing to be going to small businesses, and we have a massive pool of capital that should have been released to the states with several restrictions. So, things to keep in mind when there are a lot of great funds that are trying to address these challenges that we have, and need capital.

MR. SOLOMON: I think it’s also interesting, and Damien if you would talk a little bit; so I don’t mean to crowd this out if anybody else had other questions. But just, you have put a moral and ethical barometer on how you’re investing.

So, SBA doesn’t require you to do that; you just said this is how, with the privilege that I have and the power that I have, this is how I’m going to make the impact. And we talked about, you know, this idea of using capitalism to bring about the change you want to see; you and I have talked about that.

So, can you talk a little bit about the framework that you're, when you're having conversations with entrepreneurs and are you getting pushback, or are people sort of saying no? They're flocking to you and then saying listen, this is something I'm willing to do because it's good for me and good for my company, and I get something for it?

Or are people pushing back on you and saying actually, I don't want to talk to you because I don't have to deal with the moral and ethical stuff? How are you, as you square off with, you know, folks across the country, like what's the feedback been?

MR. DWIN: The feedback has been positive. I would say I go out of my way to avoid letters like E, S or G, and talk about risk and talk about doing right by employees. And it resonates. It resonates both with entrepreneurs and it resonates with investors.

I think from an investor perspective, there is a little desire for transparency. So, in that way, I would say this, this great organization, the SEC, has tremendous role to play in giving investors a microphone to project, with transparency, the facts in their portfolio companies.

I think we have a mechanism in place that allows investors to tell the tale of what's happening in American enterprise. I think it’s underutilized. That’s my personal opinion. As for business owners, operators, anyone who can come with thoughtful solutions on improving worker productivity has an audience.

HR is not just about litigation and avoiding lawsuits for sexual harassment or offboarding staff and onboarding staff. It is so much deeper and meaningful. But you have 300,000 heads of HR serving 50 million Americans; it’s more than did I sign you up for your 401(k), and did I get you, you know, enrolled in Obamacare?

There’s a lot more that goes into making sure that your workers are productive. I’ll give you a very specific example; I’ll give you two that are quick, obvious and rarely enacted.

If we know payday lending is a scourge, and we know 50 percent of Americans live check-to-check and don’t have $500 of liquidity, why wouldn’t we make it an employee benefit that every company offered up to $1,000 at zero percent APR for emergencies with that debt repaid, through payroll, over time.

No shame. Not going to your boss for a personal loan. Not dipping into your 401(k). Let’s make it an employee benefit, because it’s good for the company. There are very economical ways to implement that without having to hire additional staff or being invasive to the HR department.

A second example is we know most low-moderate income employees are renters, they're not owners. And we all agree in the United States how does one build wealth without owning their home? It is near impossible.

So, let's help our staff who are renting report that they pay their rent on time so that their FICO scores can go up as much as 40 points, accelerating their path to homeownership. This is a light-tough, non-invasive employee benefit that, again, breeds loyalty and boosts productivity.

When I travel to Japan working with our lenders over there; I was just in Tokyo a couple weeks ago, my colleagues in Japan speak about loyalty and the bond between employer and employee. We don't talk that way here. We must.

So, these are very practical examples that show how employers are thinking. If they bump into a financier who has knowledge and intention aligned with these things, it's good for business, everybody benefits.

Then, on the investor side of things, I'd say it's all about returns. In the end, it's about returns. You make people money, and you demonstrate that you manage risk thoughtfully, you'll receive an audience.

And I believe this employee benefits crisis is an existential risk to the capital markets. We need American labor, strong, protected, and we have to give consideration beyond the status quo of benefits today.

MS. GARRETT: Thank you, Damien and Melissa.

Does anybody else have any final questions or comments before we turn to the next topic? Okay, thank you very much. We really appreciate, your presentations were amazing and I think we all learned a lot. That is a rare applause.

MR. SOLOMON: It is rare that we ever get applause. That was a great session.

MS. GARRETT: Thanks, guys.

UNIDENTIFIED SPEAKER: That wasn't for you, Jeff. That was for them.

MR. SOLOMON: I recognize that none of that has to do with me. That was phenomenal, phenomena.

MS. GARRETT: Okay, our next topic this morning is the SEC's proposed rules and amendments related to the regulation of private fund advisors, which we heard a bit about this morning from the Chair and commissioners.

In February, 2022, the SEC released for comment a proposal for new rules and amendments under the Investment Advisors Act of 1940, with respect to private fund advisors. Some of our committee members have expressed concerns about the scope of the rule proposal, and how these proposed rules may impact early-stage venture capital funds, specifically.

We've invited two speakers to share some background on the rule proposal and their views on potential impacts. First, we welcome Alpa Patel, a partner in the investment firm's regulatory solutions group of Kirkland & Ellis law firm in Washington, D.C. Alpa practices focuses on a broad range of compliance, regulatory and legal matters affecting private funds.

She also counsels large asset management firms on issues related to the registration, structure and operations of their advisory businesses. Prior to joining Kirkland, Ms. Patel served as Branch Chief of the Private Funds Branch of the Investment Adviser Regulation Office in the SEC's Division of Investment Management. Welcome, Alpa.

And I believe we will also hear, oh, we will hear from Charles Hudson who is online with us. Charles is the Managing Partner and Founder of Precursor Ventures, an early stage venture capital firm that focuses on the first institutional round of investment for software and hardware companies.

Prior to founding Precursor Ventures, Charles was a partner at SoftTech VC. In this role, he focused on identifying investment opportunities in mobile infrastructure.

Alpa and Charles, we appreciate each of you taking the time to be with us today, and your expertise and perspectives with us. I will now turn it over to Alpa.

MS. PATEL: Thank you so much, and I appreciate you folks taking the time to listen to us talk about the private fund advisor rules. I'm going to lay out the rules, just to give everyone sort of a basic set framework of what the rules and facts will be. And then we'll hand it over to Charles to talk more sort of granular on what we think, operationally, those issues would be.

Let me just first say the former rulemaker in the Division of Investment Management that sort of really long name, that's that group that would have written this rule. So, it is, being a former rulemaking staffer, it's a privilege to be in front of you and I strongly support the mission of the agency and grateful for the opportunity to talk about this rule, in particular.

And I want to commend the committee for taking a closer look at this rule. I know it's probably not ordinarily in your purview to think about registered investment advisors and their rules because it doesn't always affect your purview.

But, as we're going to, hopefully, highlight for you today, this will have a tremendous impact, indirectly, on small companies and emerging, small businesses and emerging companies alike. So, it's important that I think your voice is heard because we heard earlier about the idea of one-size fits all, and I think this is a rule that particularly suffers from that broad brush, in general.

The rules have received a lot of attention in the industry, in particular, but also broadly as, no doubt, that you have been made aware, it represents sort of an unprecedented regulatory intervention in the private fund industry.

The private fund industry has been based on the idea that investors, sophisticated investors, are able to fend for themselves and be able to assess risks, ascertain information and make an investigative determination as to what they want to invest in.

The Commission has, obviously, in this rulemaking sort of taken a step back to re-evaluate that, and that is certainly its purview.

But as we’ll talk about today, it’s important that there’s more sort of conceptual analysis as to what does that really mean when you are re-evaluate a system since 1940, as to how private funds are separate from mutual funds. There are distinct differences.

As you’re sort of highlighted, we’re talking about accredited investors. And really, in this industry, you’re talking about qualified purchasers, which is a much higher standard. So, again, we’re talking about qualified purchasers who are institutions with $25 million of assets or individuals with $5 million of assets.

So, this is a much higher standard. There is a level of sophistication that is presumed. The fundamental points of these rules, though, is sort of re-evaluating the idea that qualified purchasers are able to negotiate the terms that they want.

And, instead, the SEC rulemaking agenda should impose upon the rules, or impose upon the operation’s very specific rules as to how these contracts and negotiations get negotiated through time.

Like I mentioned, this will have a disproportionate affect on smaller companies, whether it’s emerging managers, new managers trying to enter into the market; it’s certainly an area that we’ve seen a lack of diversity in women, people of color managing advisors.

But also, advisors that, larger advisors that invest in smaller companies. And so, when we talk about these, I don’t want to just sort of focus on, we are going to talk a lot about venture capital, but it is broader than that because there are lots of places in the registered investment advisor world that are investing in small companies, and I think it’s of particular importance to this group.

To be fair, venture capital does serve in a sort of special scenario in the world of private fund advisors. When

Dodd-Frank required all of the advisors to register, private fund advisors to register, VCs were specifically exempt, for a variety of reasons.

But ultimately, as it turns out, the regulatory regime that exists is that you are either a registered advisor or you are an exempt reporting advisor. And the obligations on exempt reporting advisors is much lower. And so, you are either a RIA or an ERA; and you'll hear us use these terms a lot, if you are above a certain threshold.

The distinction there is RIAs are subject to a sort of panopoly of rules, and the Advisors Act is a very principled space. It is not, you know, though shall do X, Y, Z; it is have a reasonable tailored application of the rules.

So, in those sense, when the rules are issued, it can be one-size fits all because it allows for interpretations depending on your size and scope of operations. So, my clients who have $50 billion in AUM have a different compliance program than an emerging manager with $100 million AUM.

Those manuals look different, they operate differently, and that makes sense. And that is a function of how the existing rules actually work.

The difference here with these rules, there is no sort of principal space concept built in anymore. These are dictating very specific requirements regardless of the size and/or operation of the funds or the advisors.

Some of the rules we're talking about today apply to registered advisors, some of them also apply to all advisors. And that is, I think, where it is sort of an important distinction that we make when discussing it. It's a difference maker in this particular rule. There are very few rules that apply to all types of advisors because Congress has decided certain advisors should be exempt from registration.

Again, regardless of size, operation, strategy, they will apply, again disproportionately, to smaller advisors and now to advisors that are out deploying capital to the types of companies that you are of interest.

So, I just want to give sort of just an example of who we're talking about. It is venture capital, of course, that we are, specifically, talking about. And when you hear these numbers, they will feel large, but I want to just bring it back to why it's important to your interest.

You can have a $3 billion VC advisor, a AUM of $3 billion. A large part of that advisor strategy, though, could very well be having a seed investment fund of say $300 million. And that fund will deploy checks of $1 million to $5 million in a bunch of seed investments.

That is capital that is going to the companies that I think is of interest to you. And so, that is a company whereas, while they may be registered or not, are going to be subject to this rule. And as we'll talk about going forward, the specifics of the rule are going to, ultimately, lead to less capital deployed.

A lot of the costs of these rules will, inevitably, be pushed down to the fund through fund expense disclosure. Which just means that $300 million fund of capital commitments that you raised from investors will just have less dollars to deploy.

So, I think that is an important piece as you think about, obviously investor protections, and is an important piece of what the Commission is seeking here. But there's another side that I think even Chairman Gensler highlighted; that there are two sides of this story that should be sort of equally dealt with and cared for.

I think where I want, if I could just go to the slide just to highlight for you the rule itself. And, as we talked about one thing, you know, we talk a lot about the economic analysis and capital formation. No doubt if you ever look at the end of these rules, the rulemakings are very long, and at the end, and I think not very many people, unless you worked in the building, you pay close attention to the economic analysis.

And in this rule, there was an interesting sort of discussion of capital formation to courses of your interest.

The capital formation discussion was really about how are we helping funds and advisors raise capital? Is this going to help or hurt the ability to raise a fund.

There was not much of a discussion, or any discussion on how does this rule affect the deployment of capital, which I think is really of importance to you. So, there should be sort of a broader concept of what is capital formation in this context?

So, if we can go to the, oh, I think I’ve got this. Okay, you can just go one, Julie, if it’s not working. There we go, okay.

So, we’ve sort of highlighted on some of the top things. As Chairman Gensler said this rule came out almost a year ago, so you can imagine the private fund industry is sort of eagerly, or not so eagerly awaiting the final results of the comment period.

And I should say, like I said, this has gotten a lot of attention. There have been over 360 comments letters. The rulemaking has been open and closed multiple times for comment letters, which is a conversation for another day of how does one propose conceptual comments that can really help shape a rulemaking in 30 days?

But broader than that, I know the staff is working very hard. They’ve met with a lot of industry participants from all sides of the aisle. So, I commend the staff, of course, for taking the time to really try to get this right, and we'll see where the final rule lands. And I think your voice will be very important to this group.

I've highlighted just a couple of points here, but we'll talk in more detail. We talked about significant compliance challenges of trying to get the rule in place. There's a lot of sort of operational expertise that is going to be required.

It is a departure from the emphasis of disclosure of advisor practices. That is the basis of fiduciary duty; the duty of care, duty of loyalty, but also a full recitation of conflicts. And that is why you had very long private placement memorandums in the private equity space.

That is why you have a lot of diligence where LPs are asking sort of detailed questions about how they deal with certain conflicts. And no doubt the structure of a private fund is inherently conflicted, and that is why there is an importance of disclosure and conversation between the two parties, to understand what are the factors at play?

Two big issues that are I do want to just highlight. One is, of course, the fact that this will apply to unregistered advisors, venture capital, as well as other non-registered folks. But also, there is a current requirement of applying retroactively.

So there's, typically in rulemaking you will see the staff take a position of any new, any new funds from here on out shall rely on X, Y, Z. This rule, specifically, we're not going to do that. We are going to, any fund that is in operation today. So, you could have a fund that's been in operation for 10 years; these rules that we're going to talk about would apply today.

Which will add a significant operational complexity to how you comply. Do we open up these LPAs? Do we re-negotiate all the terms? Because some of the provisions really will be a fundamental change of risk, reward and economic structure.

So, these are just specific pieces, just in general, to keep in mind as we talk through the very granular parts of the rule. So, we can go to the next slide.

I've got a list here of the very specific points that will apply just for registered advisors. So, again, just taking a step back, you can register with the SEC if you have over $100 million in assets. And, again, I know that's a large number; it's not that large when you think about who's actually deploying capital. So, you know, even the registered advisor is of importance to this particular space.

So, the first three here are not particularly controversial, to be frank. You know, if we had all day, I'd be happy to talk through the details of where I think some parts of these rules are misguided or we need to make some adjustments. But for purposes of this audience, I don’t want to spend too much time talking about issues that I think are sort of not germane to this group, in particular.

And they’ve certainly received plenty of comments from industry participants. But just so you’re aware, there will be requirement, there would be requirement for all funds to receive an annual audit. This is not that large of a change.

Most funds already get an annual audit via the requirements of the custody rule, and LPs negotiate for this as a general protection in a post-Madoff world where there’s a comfort in having a safety of assets to check every year.

Even though there’s a cost to this, significant cost to these annual audits, which can be $50 or $60 every year. That has been a negotiated piece that all advisors, most advisors, most funds have sort of relented to, understanding the importance.

Advisory-led secondary transactions. These are commonly -- as sort of recaps or continuation funds. It’s a growing area of sort of a, really, just a liquidity creation for funds. I know we heard the last panel talk about waiting for liquidity.

Right, you want to wait for this fund, this asset to sort of get to a point to sell. You don’t, necessarily, want to sell it to the open market. So, you can, instead, sort of arrange for a different type of liquidity option so that the investors in the current fund are able to obtain liquidity.

This would require certain parameters to be imposed on those types of transactions. A written annual compliance review; not a big deal. This is a rule that already applies to all advisors. It's just now requiring an actual written document which I believe most do as it stands today.

The quarterly states is where it's worth talking of sort of in detail about the operational cost. That it's going to be, ultimately, one very difficult for smaller types of advisors to absorb handling this type of quarterly reporting. It will now require the detailed prescriptive reporting on a quarterly basis within 45 days.

In theory, that sounds okay. It's actually quite complicated, as you can imagine. If you've got a portfolio you've got to pull information to, you've got to provide it in a particular way. Administrators, no doubt, will need to be hired. Staff will need to be expanded to be able to meet this type of reporting requirement.

Certainly for the smaller end of the firms that may not already have this built in place. Many advisors do have robust reporting requirements because LPs have naturally negotiated for these rights.

We're now sort of in a different world where you would have to follow through a very specific line item of points. So, from the quarterly statements perspective, you can imagine smaller advisors having more difficulty complying.

These are the types of things were the costs would, most definitely, be pushed down to investors to bear. So, from their perspective, they are now paying for this extra cost to the fund expense. You've made the product more expensive for them, as well as less capital to deploy to the portfolio companies.

And I guess maybe we can go to the next slide there to talk through what I would call the issues that are really sort of the most important, right? These are the prohibited activities, and they're most important because they are really digging into the fundamental nature of how private funds have worked forever.

But also because they apply to all advisors, not just registered; also exempt reporting advisors, non-U.S. advisors that are not registered. So, it's a very broad view as to what's, who comes into scope and who will have to think through this.

These prohibited activities are outright bans on certain activities engaged in by an investment advisor. A lot of these activities are parts of things that are negotiated with LPs on the way in.

And just to sort of give you a sense, you know, when an advisor goes out to raise a fund, it's not like they can just close on day one. There's a long, protracted negotiation time period and dance that we do with LP counsel and, typically, on the advisor side of these arrangements. And I can assure you they are quite capable of advocating for their clients and their LP interest in negotiating side letter terms and terms of whether or not they're going to come into the fund.

The provisions that are being prohibited today are hot topic issues that are negotiated. So, there's commercial acceptance and commercial use as to how the advisors and the LPs have sort of come to detente to have investors come into the fund and decide they want to be an investor in the fund based on these specific points.

And as I mentioned, the grandfathering points; there is no grandfathering piece in these particular rules. If these provisions are applied retroactively, there could be very costly and just disruptive, in general, with out the funds were originally intended to operate.

In addition, there are a couple of other points here so that the rule would make several types of activities illegal, and I just want to highlight a few of them. You can read them here. The one that is really of importance is the advisor indemnification.

Where, we're going to talk sort of esoterically, but when I think through how that actually applies to advisors when deploying capital and when they're actually working with small businesses. But the indemnification standard change would effectively be, basically, shifting from a gross to a simple negligence standard.

So, ultimately, right now LPAs typically have permission to indemnify personnel for various types of activities. And as you can imagine, in a litigious environment, constantly general partners, advisors, personnel at funds are generally often named in litigation, whether it's a loss of investment or a disgruntled shareholder of the portfolio company.

By changing the indemnification standard, you're effectively changing the risk and reward that an investor has signed up for. So, if I am a venture capital firm, if I'm a private equity firm, regardless of, you know, talking about VC, but this is applicable to the private equity role, as well.

The value they bring to the table is not just making an investment. The value they bring is working with the founders. Rolling up sleeves, getting into the company, working with them to grow them. Helping them find suppliers, sitting on their boards or, just generally being advisors and consultants.

That is the value of the general piece of why certain advisors get deals that other don’t, right? Advisors are competing against themselves for deal flow, and trying to find that next great company. They compete against each other with the idea of look at all these great companies I’ve helped; let me show you how I can help you.

By changing the indemnification standard you’ve, ultimately, changed how much risk somebody’s willing to take on in getting involved with a private company. By changing this indemnification standard, you are opening up advisors, as well as personnel to unlimited personal liability.

It will, inevitably, make folks less inclined to want to get heavily involved in the portfolio company. That hurts sort of everybody involved here. That hurts the portfolio company who’s really seeking advice and expertise from people who have done this before and have a play book.

It hurts LPs who are clearly seeking a high risk, high reward investment in the private fund in the first place. And I’ll just point out even the Institutional Limited Partners Association, sort of a trade association of LPs, has highlighted this as a problem because they recognize that this is an important piece of the risk-reward that LPs want on the way in.

So, I just, this is one of the pieces I think we’ve seen the most commentary from from the industry and really sort of belies the misunderstanding, I think, of how private funds sort of operate. It's not tied to standards of care and the fiduciary duty. This is really a concept of trying to protect against being named in litigation that, you know, advisors operating in good faith should be protected from.

There's also a couple of extra points here that talk through the fee prohibitions. You'll see the charging fees and expenses related to portfolio companies on a non-pro rata basis. These are in addition to just the generic terms that are negotiated.

Many advisors will negotiate with institutional LPs coming into the fund, but also on the side, and will create sort of additional relationships. These are pieces of the negotiations that are typically just dealt with individually, and outright prohibition just sort of takes away any ability for advisors and investors to decide does it make sense in this case.

That first bullet there under the prohibited practices is particularly important, where the idea of not charging certain fees and expenses for services or related to compliance and regulatory issues.

Brand new advisors sometimes negotiate this as a particular piece because it is important; they don't have a lot of operating capital. And so, if there is a regulatory charge, they want to be able to pass that through. LPs with full disclosure should be in a position to be able to accept that that is a fund expense if that's sort of how they are seeking to support an advisor on the way out.

There's also a long sort of provision in the rule that talks through side letters. And I know many of you maybe not have a ton of familiarity with side letters, but it is, you know, an investor's coming into the main fund. But they may also have sort of esoteric requests of the advisor because of their own individual circumstances; whether it's tax related, reporting related.

The proposed rule has sort of a very hands-off, or a very sort of hands-on approach, prohibiting certain types of side letters. And again, I would encourage the staff of the SEC to pay attention to the industry letters that have come in.

ILPA, the firm, the group we just mentioned also came out saying this doesn't help the limited partners in the way that you think it does. Because we are in a position where sometimes we want to pay for these things.

Sometimes an anchor investor, to start out a brand new manager, is interested in seeding the fund, seeding the advisor. But we need a little bit more for that, right? We want more information. We want to be able to negotiate for additional pieces of economics in order to take on that risk.

So, broad-based prohibitions that are sort of, that we were talking about here will have unintended consequences that I think it is important for you folks to sort of sit, as you’re thinking about how this will trickle down to the portfolio companies, to be aware that that, as we paint with a broad brush here, that there’s probably better ways to achieve the ultimate view that the SEC staff and the Commission is seeking to here.

So, that’s the rule. I want to hand it over to Charles who, you know, does this for a living on a day-to-day basis and actually deploying capital. And we’re happy to, you know, between the two of us, answer your questions. But Charles, let me hand it over to you.

MR. HUDSON: Thank you so much, Alpa.

I thought it might just be helpful for the group to understand, in kind of more concrete terms, some of the things that Alpa mentioned, and how I think they would affect a manager like me.

So, I’ll just tell you a little bit about myself. I’m originally from Michigan, but have been in the venture capital industry for about 20 years now. I was a partner at a larger fund and decided to spin off about nine years ago and start my own firm. Because I felt like there were a lot of people, both across the country and from under-represented groups who weren’t getting what I thought was fair access to capital.

And so, when I started my fund, our first fund was $15 million in size which, by venture capital standards is tiny. And to put some of these concepts that Alpa’s mentioned into context for you, our $15 million fund had about $300,000 a year to run the entire fund; all ops costs, salaries. So, I didn’t even have enough money to be able to afford another team member.

Everything that needed to be done on the fund side, from capital formation and fundraising to choosing and supporting the investments that we backed, to handling whatever compliance and reporting requirements needed to be done, those things all fell on me, as the Founder and GP.

And things were pretty tight and there was a lot of work for me to do. And so, I grateful to have the opportunity to share my experience because I think some of these things would have made succeeding as a brand new fund manager who was trying to bring capital to people who’ve had less access in the past, it would have made my life significantly more challenging.

And just to talk a little bit about our fund strategy, you know, we are really focused on making sure we get capital to folks who are starting companies from scratch. And many of the people that we work with are first-time founders.

They’re people who’ve never done this before. They were maybe an executive at a tech company. Or maybe they were a person with a great idea who really wants to see it exist in the world. And we really want to partner with those people from day one, to try to help them be successful.

And part of the reason they choose us over other people is because we’re willing to get involved, roll up our sleeves, and help those founders think through really difficult business problems. Those business problems could be anything from strategy to interpersonal challenges that a co-founder’s having with a member of their management team or their co-founder.

And the founders we work with really value our willingness to jump in there with them, roll up our sleeves, sit side-by-side with them to help them solve really difficult problems sometimes.

And I think I really enjoy the fact that I don’t have to think or sort of self-censor myself when it comes to the negligence standard that’s being proposed here.

And I can tell you that it would cause me and the members of my team, I think, to really think twice about how involved and how helpful and how in the weeds we want to get with these founders if they have some of these typical challenges that they face.

If it would expose them, individually, the firm or me to greater liability, I think it would impact our decision making, I think, to the detriment of those companies being successful. Many of them come to us because we have the experience across hundreds of investments of how to help advise them on these issues that can be incredibly, as you can imagine, stressful for them as founders. And they're really looking for someone who they trust to be a good sounding board.

I would also just say that the side letter piece is also really important to me. In order to get our fund off the ground, we had a number of limited partners who asked for specific things. And many of the things they asked for were their own bespoke reporting requirements.

For example, we have a few of our limited partners who are very interested in the racial and ethic breakdown of the portfolio companies that we back. We have a few others that are very interested in the geographical breakdown, and they've asked me for custom reporting.

This is reporting that's very, very important for them in meeting their mandates when it comes to making sure the money that they're giving to advisors like myself is ending up in the communities that they care about.

But it's not something that every one of my investors has a deep interest in reviewing or understanding. And it was great that we were able to provide them with what they needed without, necessarily, having to make it available to everyone.

And so, I really think it’s important for everyone here to understand it’s really hard to get these funds off the ground. I thought I would have an easier experience. I’d been a partner at a pretty well-established fund for five years, and even I struggled out of the gate to get our first and second funds done.

And even with our second fund, then we had enough resources to bring on one full-time staff member. So, these things really do impact fund managers, and I think it’s not so much the impact on fund managers that’s important, it’s really important that the fund managers are the ones that are distributing this capital to founders.

And to give you, sometimes I know in venture capital we often think of the really big, famous firms in our industry, the medium venture capital fund is $50 million. So, most of the funds in our industry are not these gigantic firms with billions of dollars of assets under management.

Most of the funds in our industry are relatively small, and many of these proposed activities would make their lives difficult.

And I can tell you, as someone who’s been very involved in our industry for 20 years, much of the change that we want to see in venture capital in terms of who gets to participate as venture capitalists, what companies ultimately get funded, how that wealth creation is spread throughout our country and across all people; a lot of that activity is happening at small, emerging, up and coming funds.

And I really appreciate you giving me a chance to answer any questions you have, and share the perspective of someone who is, himself, an entrepreneurial fund manager who started his own fund and is continue to try to create opportunities for others.

MS. PATEL: Can I just add one point, too? Charles made a great point, right? We're talking about these rules; it's important to think of the broader ecosystem, as well. There is a cumulative cost to rulemaking, and this Commission has been very active.

And each rule that comes out has sort of like a death by a thousand cuts, right? The economic analysis that is within each rule doesn't have to take into account all of the other rules that are going on at the same time, right?

So, at the current moment, you've got the marketing rule that applied to registered investment advisors. You've got these rules that have been proposed. A cybersecurity rule that would apply to advisors. An ESG rule.

Each individual sort of feels like no big deal; well, this one aside. But the thought of all together is a cumulative affect and, certainly you know, we talk about barriers to entry.

I'm one that Charles didn't have a separate CCO, right, when he's running the shop by himself. There's no person there that is able to sort of keep an eye on all the rules that are now going to apply to a firm, and actually monitor that on a daily basis, in addition to running the show.

And this is not to be an abdication of investor protection. And, yes, you're in the industry; you have obligations, but there should be a sort of sense of barrier restraints are important if you make it so that the rulebook is so big that only the largest of the large can sort of operate efficiently and make profits.

You are going to keep out the new face of what this industry is supposed to look like and that, I think, is a broader problem of what we sort of generally look at at the advisors that we operate with.

MR. SOLOMON: Can we ask a couple, make sure we open it up to questions? I have a few, but I always have a few, so I want to make sure other people get a chance to ask.

Donnel, go ahead. Sorry.

MR. BAIRD: Alpa, to your last comment, so like this rule would be the straw that broke the camel's back?

MS. PATEL: Well, I wouldn’t say that, right? I mean, I think --

MR. BAIRD: Okay.

MS. PATEL: -- Americans are ingenious, like we will find a way. But there is a sort of concept of how much can one take. I do think this, in particular, the prohibited practices applying to non-registered advisors, is problematic. Because those, you know, those are naturally smallest, they’re the smallest firms, yet are still now being subject to particular advisors.

So, it’s not like any one particular rule. I just think there’s a generic sort of thought of as these rules go forward and the rulemaking agenda is still to come, like we are not over; there’s more to come.

So, it’s sort of a look at this holistically. And when we’re thinking about does a particular rule make sense, understanding the compliance burden to the people that have to operate with them.

MR. BAIRD: Great, and then my question, thank you; my question for Charles.

Charles, good to see you. I want to make the comment that Charles has a really incredible reputation in the world of venture capital and early stage founders for being uniquely hands-on. So, it is good to have you here to make comments on this, Charles.

I do want to differentiate that you’re firm’s hands-on nature is unique, right, and is not representative of the way most people experience the venture capital industry.

Can you give us a specific example of the kind of fiduciary risk or liability risk in providing advice that, you know, you would kind of pull back from providing a founder with advice? And where does that, where does that conflict with what a founder talking to you versus talking their corporate counsel; like where, I just, I’m having difficulty kind of sifting through what’s helpful here and what’s generic.

MR. HUDSON: I think it’s an excellent question. I can give you, and it’s probably hard for me to pick a specific one. I can give you a flavor of the activities that we involve in where I would probably think much harder about how far we want to get involved.

You know, most of the companies we invest in, it’s two or three founders who are trying to build something from scratch while also kind of keep their interpersonal relationship intact. And oftentimes, as you can imagine, sometimes those relationships get to a place where the two individuals can no longer continue to work together in the same company.

We play, oftentimes, the pre-active role in helping founders negotiate those conversations, and get to a resolution that allows the company to proceed with the right set of people still around the table on a go-forward basis. Those are often, as you can imagine, quite contentious conversations.

And they sometimes to result in the person winds up not remaining part of the company, pursuing various types of action. That's something I would, and those end up being some of the most important conversations that the CEOs and co-founders have together, and we get pretty involved in those. That's one area where I think I would probably start to think twice, and those end up being kind of company-defining moments.

The other ones are, you know, pretty big strategy pivots that put the company on a different trajectory than they originally were on. Again, tends to be one of these foundational things. And what I can tell you is this; not every shareholder has the same point of view about a company's strategic decisions.

So, if a company decides to go left instead of right, that can also sometimes create some level of angst among shareholders. So, there's a bunch of things that we help companies with on both the sort of interpersonal, I'd say leadership development side for the founders, and on the kind of company strategy side with these big shifts.

Or even fundraising, helping people with fundraising are things where right now I think what’s best for the company. What can we do to bring our experiences to the table and help them? And those are what I think I’d probably think twice, or even three times, about well, what potential exposure am I taking on for our firm by getting more involved in these kind of company-level issues. I hope that helps.

MR. BAIRD: Very helpful. Thank you.

MR. SEATS: Hey, Charles, this is Jason Seats. Good to see your face.

MR. HUDSON: Hey, Jason.

MR. SEATS: We’ve lived through some of those situations together.

MR. HUDSON: Yes.

MR. SEATS: So, I think a couple things I’d add on that is one of the things that’s interesting, and this is sort of brought up in different context today already; there is a default fail scenario that is very, very, very common, especially in early-stage investing in venture.

It’s the most common outcomes that companies are going to fail. And the problem is that these sticky situations are no, even in retrospect, you don’t know what the right answer was. And so, there’s significant open opportunity for everyone to point fingers and try to debate, after the fact, what, like was this advice the right advice?

You might not ever even know that. And so, this opening this broad window of liability really is a, puts a damper on --

MR. HUDSON: Well, as a founder, I'd be thrilled to have additional liabilities placed on my investors so they could shut up and keep their advice to themselves. That's my framework on these questions, but go ahead.

MR. SEATS: Got it, got it. Understood. So, I think the other point I would bring up, which Alpa mentioned, which I don't want to, I want to sort of underscore is the role, is ILPA's view on this. Which, I-L-P-A, the Institutional Limited Partner Association; this is a trade organization that is all of the most sophisticated limited partners.

So, these are, these are the people who know the most about this asset class who are working together to be on one side of the table with fund managers on the other. And so, they are a very conservative group. And the way that they think about what their protections re is very, very high.

And for them to think that these are an overreach, I think it's important to sort of underscore that the most sophisticated investors in funds think that these protections aren't helping them.

MS. GARRETT: Bert?

MR. FOX: Jason, you took my first question, which was I was thinking about the liability rules. And then, given that, you know, I heard 80 percent throughout I actually felt that was probably low in terms of venture stage companies that end up failing of not being successful, right?

I mean, you know, so I think that question is completely valid, and I'd want to understand more about what that does, right? Or would that even stop potential investment, right?

But my second question gets into totally hear the points that were raised; I'm trying to think in my head maybe it's the accountant part of me that, you know, likes principals versus rules and, you know, standard setting, right, of where do you start drawing the line, right?

You know, because before I think you said maybe venture capital funds were scoped out. I mean, we have hedge funds that are doing venture capital investment. I mean, you know, the lines are getting blurred, right? I'm not even sure what is truly defined as a venture capital fund anymore, right?

And so, I'm just trying to think through like, you know, if you; maybe I'll post it to you, Alpa, in terms of like if you had to say hey, where would I draw a line, is it size, is it cumulative size?

Because I mean, and then do you start having some of those bright lines, there's a whole bunch of lawyers and accountants and others that are really good at structuring around them, right? And so, can you help us think through maybe some ways to think about that, as well?

MS. PATEL: Look, I think it's a fair point, right, that the VC exemption exists because of a variety of reasons. Again, we could have a full seminar on the legislative history of Dodd-Frank of why VC got exempted from this. It is not the SEC's typical avenue to regulate based on strategy. That has never been it; it has always been size, and you're either in or your out.

I think, actually trying to find the right level is sort of the wrong way to look at this, because you're right, there is probably some AUM size that can bear this cost without it having a big affect because the percentage of fund expenses just won't, it'll be negligible.

I think it's more just taking a step back and thinking about it philosophically; what are we talking about here, right? And that is where I sort of, I think the PE and VCs and the hedge funds of the world are sort of aligned in this idea of these are sophisticated LPs.

I go back to this a lot because I think I just, I wear the scars of negotiating with them. And so, the notion that they, you know, this group of individuals needs a lot of help is very counter to my experience in dealing with very sophisticated LPs that understand the risk and reward of going in.

So, I think the concept of trying to slice and dice this is probably not going to serve anybody well because, to your point, if I set up a $500 million AUM fund, I promise you I am now in the business of raising $495 million of capital across the board.

And so, that’s not really solving sort of a philosophical view. And so, it’s more about we’re blurring the line, which is, I think the SEC has acknowledged they’re blurring the line, purposely, between private funds and registered investment companies.

Yet, that’s not necessarily what investors want, right? I invest in my Vanguard Star Index for certain reasons, and then I invest in, you know, my private funds for different reasons. And I think an investor should be able to make those distinct differences, and understand there’s different risk and reward sort of solved in there.

So, while you think about, you know, we’re here talking about small businesses. Like I said, you can have Charles’ shop whose got, you know, a $50 million fund investing in small business. My $3 billion client is also providing those checks.

So, do you draw the line there? Like $3 billion is a large number. I don’t know that that’s still the right answer for effecting behavior in an appropriate way.

MS. WASHER: So, where did the drive to make this rule change come from? What are we trying to protect fuller? Can you kind of go back to what are we trying to protect for?

MS. PATEL: Yes.

MS. WASHER: And make your way through that way.

MS. PATEL: This is not, this has been sort of, you know, just to give a quick history. 2012, you know, was the first time registered, or private funds had to register. The SEC has been, had been trying to get them to register for a long time. It was sort of seen as a loophole that private funds did not have to register.

There was a part of the statute that allowed, if you had less than 15 clients, you didn’t have to register. But clients was defined as funds, so you had a lot of people with 14 clients and stayed at that size forever.

The SEC issued a rule in the 2000's that was struck down by a court case. And so, that might happen and you should sort of never, you know, as a regulation, never let a financial crisis go without sticking in legislation that you think you’ve been trying to get done for a long time.

And admirably so, because private funds, you know, there was a concept of these needs to be regulated. And so, they were brought in as registered advisors. And so, we've now had them for 10 years, right, as registered, registered sort of subject to the Advisors Act.

From day one, I think the thought was there's not enough transparency. So, I don't want to portray this rulemaking as sort of out of the blue; there have been enforcement cases by the SEC staff that have gone in in exams and seen problematic behavior.

You've seen adjustments by the industry to really beef up when it comes to compliance, regulatory counsel, all of those things. It's sort of slow, a slow sort of march towards having more compliance and regulation applying to these arrangements.

But effectively, over the course of the years you've seen, through exams, through enforcement actions behavior that is counter to what is written in the document. You know, we hang out hat on this idea that you have sophisticated LPs negotiating with advisors.

And everybody's come to the table. They've fended for themselves. They are able to sort of come to terms on what is going to happen in this fund, but what we've seen play out, in certain circumstances, is not everybody living to the bargain of that negotiation.

And there’s a level of transparency that does not exist at times. And so that, I think, is a core concept behind a rulemaking. ILPA has constant, has sort of been an advocate for requiring more transparency.

And while we sit here an talk about LPs being able to negotiate particular terms, I’m sure they would say we don’t get all the terms that we want. That we can’t get, you know, we need to invest in this particular asset; we cannot get all the terms and disclosure that we want.

And the theory behind a lot of this is if you’re not able to negotiate those terms, we want to impose those terms for you. So, it doesn’t come out of thin air. It comes from a place of investor protection.

It’s just telling that not all the investors want that level of protection. And then, on the other side, you know, it is not as if there is a complete lack of negotiating skills on the other side, negotiating and bargaining on the other side to be able to say we want X and not Y.

MS. WASHER: But I would think there could be a way to have transparency without requiring specific, you know; you know, I’ve always through quarterly reporting was sometimes not beneficial. It’s very costly for small companies. It’s going to be costly for small funds.

And you’re still under, as a public company, we were still under Reg FD. So, if something untoward happened, or something significant happened, we were still going to have to report it, regardless of quarterly reporting.

So, to require transparency without all these restrictions and prescribed requirements seems like the better way to go. Because I think transparency, all of us would agree that transparency is missing.

MR. SOLOMON: Bailey?

MS. DEVRIES: Yeah, so I agree with that comment. It is about the transparency. If that is the outcome that we're trying to solve for, this is a gross overreach, right? Because this is putting in place restrictions that are going to have a chilling effect on the creation of new fund managers and capital flow into small businesses.

It will also have an affect on the types of fund-to-funds that actually invest in those emerging managers, as well. And it will have a huge affect not just on venture, but smaller funds all together. So, we shouldn't just be talking about venture.

We should also be talking about all the SBIC funds that are exempt from SEC registration. That's over 300 firms that provide the majority or money to the lower, lower end of the middle market and support the industrial transformation and, it was just the timing, also, couldn't be worse.

And then you talk about having to increase management fees which then will lead to lower netreturns, and environment where we have a higher cost of capital. So, nobody's going to put money and risk capital when they're getting compensated less for it.

And it's, it's just, sorry I have strong feelings on it. But it's completely misaligned, which is why I think you've got ILPA speaking up the way that they are. Alignment is everything, and this is creating friction between LP and GP.

And why write regulations around the exception of those, you know, off cases where there's been a major issue versus writing regulation for the 80 percent? This could significantly impact the country overall in terms of national security investment, manufacturing investment, supply chain investment, innovation investment. It just could be devastating. So, that's all I will say.

MR. SOLOMON: So, let me ask a couple questions because you've hit it spot on. I think there's listening people who say I just don't want the personal liability. Like and then, Charles, I think you've highlighted that; like you'll think twice about how much you get involved. You just don't want the personal liability. Jason said the same thing.

So, if nothing else, the take away, because we're ultimately responsible for creating recommendations here;

there's elements of this that just really will make people think twice, regardless of size, as to whether or not they even want to be involved in the venture community.

And that may be intended, I don't know. But it seems to me, I'll give everyone the benefit of the doubt that that's an unintended consequence of an overreaching piece of regulation that maybe hasn't been well thought through.

These are messy companies. I take your point, Donnel; I think what Charles does is unique in the way that Charles does it. But I don't know one venture firm that doesn't spend a good deal of their time working in the inner bowels of a company to help make it work.

It may not be, it may not be like they just, they all think they do, right? And so, the question is whether they do or they don't, they all think they do. And if they think they have liability in doing it, they just won't

And that's, I just, I'm not smart enough to know, in those particular instances, whether or not that just ends their willingness to get in. I've never had a venture firm come in and pitch me for an allocation and say I don't get involved, right?

That's, they all think they do. I take your point; some are better than others. So, I just feel like when we're talking about this, is there a recommendation in your question where we can look to do this concept we floated at the committee a few times, like chaperoning?

So, we all know when venture funds or private equity funds are first-time funds is smaller funds raised, they generally have anchors. Those anchors do a good job at negotiating, as you've highlighted and, I think Charles, as you've pointed out, as well.

If there is an anchor in there that the SEC can recognize by some metric, right? Would it be then okay not to have, like in other words, I think the SEC may be going after and, I don't know, I'd like to hear, is if there's no sophisticated investor involved in negotiating these things, then there's some things that unsophisticated investors might want to have as protections.

And if there's nobody who is driving that, as a lead invest, to get to those terms, yeah, then I can certainly see there's a higher probability of individual investors getting involved in something that may just not work out.

So, instead of looking at as size, should we look at it as this chaperoning mechanism, whereas if there's a sophisticated investor defined by some pre-existing categorization that's involved in driving that, is that a solution that you think you heard? Or is that, are just chasing after --

MS. PATEL: You know, this committee has spoken a lot about what is an accredited investor and what is not, right? I think in that place you get into a point of making policy determinations as to who is sophisticated enough to manage this.

I think if you take a step back, these funds are, again, qualified, most of them, 3(c)7 funds qualified purchasers. By definition, the securities rules apply a level of sophistication tied to assets, rightly or wrongly. Maybe it should be broader, in addition.

But at least one can say an institution with $25 million in investable assets can either bear the risk, be sophisticated itself enough, or able to purchase sophistication, right? You hire a consultant to help you manage your investments. And so, I don't think you necessarily need a lead investor; you have a 3(c)7 fund. You have all sophisticated investors.

MS. WASHER: You know, doesn't this go back to, in some ways, like we talked about before, about shouldn't there be enforcement and consequences for the bad actors? But not, then, making a whole bunch of rules for the 90 percent of people that are not bad actors that may or may not have prevented that bad actor.

I think we've had this conversation many times before. And I think we've always landed on enforce and find the bad actors, and have consequences for them. But let's not make all the other actors in the space have to jump through more hoops just because there was that one bad actor, or two or three.

MR. FOX: Can I ask a separate question maybe, because it struck me, Jason, to your point that the largest group of investors in the space, right, are banded together. And not knowing the space as well as a lot of others in this room, how big of a, I mean, like are there other sets of investors that are actually, are asking or proponents of these rules?

Because, I mean, I'm kind of getting back to Sue's earlier question; like what's the problem we're trying to solve? And if the actual investors are not asking for this, then you know, should there almost be a reset to go back and actually figure out what the investors in the space are actually looking for, and actually try to meet them? I don't know.

MS. PATEL: Look, it's a fair point. You know, we've talked about ILPA because they are sort of the advocate of the group. But they are not the only investors; there are others who are, you know, there are certainly sovereign investment funds who I would not say lack any ability to negotiate terms in coming into a fund.

The folks that are in ILPA are the traditional pension plans, you know. Maybe not even the CalPERS of the world that really do have large sort of bargaining power that some of the smaller ones, that are able to at least sort of try to create a level playing field, and they operate together in that way.

And they have been a driving force behind me. They’ve been a vocal advocate, and advocated through the years for the Commission, the staff, up and down, up and down this building about areas that need to be focused.

Whether it’s on the exams; what should be focused. We’re not getting particular information. So, I think they are doing important work, and I think this is the genesis, and a lot of these rules come from their advocacy.

But I agree, I think the rules that ultimately landed were just too far. I also think we should be taking things with a grain of salt in the sense that the investors have their perspective and will want, you know, X, Y, Z. So, even if you met what the investors sort of line of sight is here, that is not to say that that is the right answer for balancing the pie.

MR. YADLEY: Yeah, and Donnel I want to make sure, because Donnel had a comment.

MS. GARRETT: Yeah, and just so we know, we’re going to have to wrap up soon. But Donnel, and then I think we might want to propose some recommendations and vote on them. Maybe we do, but maybe, but I have some thoughts on that.

MR. YADLEY: Could you just clarify the smaller, you said all advisors, the small advisors, like $4 or $5 million; are they caught up in this, in all rules?

MS. PATEL: In that second set of rules, the prohibited practices.

MR. YADLEY: Right.

MS. PATEL: All advisors. Even those that might be registered with the states, so --

MR. YADLEY: Yeah, because that seems counter, I mean, you have these three tiers of the, you know, small and over $110 and all that stuff, but this drags everybody into it.

MS. PATEL: Yeah.

MR. YADLEY: To some of those, and the definitions cover all advisors?

MS. PATEL: Yes.

MS. MEHTA: I just wanted to reiterate I think the, you know, the negligence standard is a scary one. It leaves a lot of interpretation. You know, a lot of these, a lot of fund managers and investment professionals would also be on boards at the company level, and already have a duty of care, duty of loyalty.

And so, you know, and then I know that the quarterly reporting doesn’t apply to ERAs, but I’m not sure what level of work that would require of their portfolio companies, in which we are also invested.

And I don’t think anyone wants portfolio, smaller companies to have to, then, spend all this time reporting out on a quarterly basis; they want them focused on running their business. So, I just think, I agree with what has been said, and I’ve had reservations about this, and I was sort of waiting to see how it was going to evolve.

But, you know, I think it’s antithetical to capital formation and fundraising when you start to overlay more and more regulations on a lot of these fund managers, especially smaller ones. You know, it will have a trickle down affect on capital formation, as well.

MR. BAIRD: Venture capital is the wild, wild west. It’s super racist. It’s super sexist. It’s entirely unrelated. And I am not in favor of generic like anti-regulatory responses. However, there may be specific things in these rules that are problematic like, you know, cost of audits below.

But, certainly, the idea that VCs shouldn’t bear legal responsibility for the advice or whatever that they provide founders, like that is, that is not something that this committee should embrace. Like that is not a real thing.

There may be other highly problematic parts of this law, but I guess I'd be worried because we haven't really been clearly presented with the rationale for the law here today. Like there hasn't been a case for why whoever came out with the rule came out with it. And so, it's hard to really see clearly on this. Thank you.

MR. SOLOMON: With that, I think we're breaking for lunch.

Thank you, Alpa. It's really super helpful.

Thanks, everybody, for the comments, and we'll reconvene after lunch.

(Off the record.)

MS. GARRETT: We had a great discussion this morning on a number of topics. We ended with a discussion on the SEC's proposed rules and amendments related to the regulation of private fund advisors. I'm going to try to sum up where I think, possibly, we've come for a recommendation from our committee, recognizing from the outset that we were presented with a lot of information, and this is a big area.

But we do want the SEC to really consider what problem they are trying to solve with this regulation. And we encourage the SEC to look carefully at rules that are this encompassing and that are one-size-fits-all as they may have an adverse impact on small funds that attract sophisticated investors for small companies and growth. We also urge the commission to closely examine how this proposed rule will affect capital deployment.

How do people feel about that proposed recommendation in this rule?

MR. SOLOMON: I like it.

MS. GARRETT: Okay.

MR. BAIRD: Move to put that in resolution form.

MR. SOLOMON: I would second.

MS. GARRETT: Thank you.

So, all in favor of that as a recommendation from our committee?

(Chorus of ayes.)

MS. GARRETT: Anybody opposed to that?

(No response.)

MS. GARRETT: Great. Thank you for the recommendation on the private fund proposal.

And now we will go into our afternoon session. Our first afternoon agenda topic is the role of broker/dealer investment research for small or public companies. The committee will discuss the current availability of public company investment research prepared by broker/dealers including what impact the availability of investment research has on liquidity. First of all, with public companies who uses and pays for this analysis; how that analysis reaches investors, including retail investors; and the value of the investment research for investors. We have two speakers with us today to share their experience on this topic.

First, we welcome Charles Bobrinksoy. Sorry, I'm sure I butchered that name, Vice Chairman and head of the investment group at Ariel Investments. Charles is joining us from Chicago where he manages the firm's focused value strategy, an all-cap concentrated portfolio of U.S. stocks. Prior to joining Ariel, Charles was an investment banker at Salomon Brothers and its successor company CitiGroup, where he served as Managing Director and Head of North American Investment Banking Branch Offices.

We also welcome Amy Kroll, a Partner at the law firm of Morgan Lewis. Amy counsels financial institutions on U.S. regulatory requirements and best practices related to broker/dealer activities. She advises clients on issues related to the implementation of new regulations, acquisition and sell of broker/dealers, and regulations related to capital markets such as research activities and research analysts, participation in public offerings, supervisory controls and internal controls, and cross-border securities activities.

Charles and Amy, we appreciate each of you taking the time to be with us today. And I will now turn it over to

Charles.

MR. BOBRINSKOY: Thank you very much. Thank you for that introduction. I think Amy and I agreed I would go first. Our firm is 40 years old. Ariel investments is a small- and mid-cap investing firm, so this topic is very important to us. As was stated, I was an investment banker in a prior life. I ran the Chicago office of Salomon Brothers and participated in a lot of IPOs in my career. What I'm going to do is give a little background on how we got to the current system. Then Amy's going to walk through some of the laws involved in that current system. And then I'm going to sum up by saying why it's important and why we do have a problem today with lack of research for smaller companies.

So, as many of you know, in 1933 Congress passed the Securities Act, which required any company offering securities to the public to file a registration statement with the SEC. The SEC would then review that statement and could mandate changes to that registration statement. And critically, if the company ended up losing money, investors could sue and could look to that document for misleading information.

The law stated that the document needed to include all relevant information, all material information that a reasonable person would need to consider in buying that security. But importantly, that didn’t mean including projections because if something ever went wrong and a company ever went bankrupt, by definition those projections would end up being wrong and you could easily be sued for having put those projections in.

So, what happened over time was that that document became a list of risks. It became literally 10 to 20 pages of reasons why the company could go under, anything from not having competitive products to not having access to capital to regulatory problems. The document became a disclosure of risks. So, because what matters in setting the price of a company is the future, and because that document could not include projections, what developed was a system based on a lead underwriter, co-lead underwriters and a syndicate of underwriters.

And those underwriters performed four functions. First, they helped write that prospectus. Second and very importantly, they helped sell those securities. They had a network of salespeople that talked to institutional buyers every day in a way that no company ever could on its own. Third, they provided liquidity in the market by making a market for that security. The lead underwriter, the lead investment bank in an IPO was, by custom, required to have what’s called a syndicate bid where that firm would backstop the deal and buy back securities if people wanted to the next day.

Very importantly, that firm set the price so that the stock was intended to trade up, the so-called IPO discount where stocks on average traded up about 10 percent on their first day. And even going forward for months on end, that lead investment bank and the syndicate investment banks would provide liquidity for that IPO in case there was a seller that wanted to sell or something went wrong.

Very importantly, fourth, that firm provided research. And while there was nothing contractual, it was absolutely part of the process of selecting an investment bank to lead the IPO and picking co-managers and picking syndicate managers. There was an expectation that they would provide research. Very importantly, those firms could publish projections. And an institutional investor like myself could look to those projections, have conversations with analysts with whom we had experience, where we could judge the effectiveness and knowledge of that analyst, make our own adjustments but have a basis upon which to put together our own models for future profitability, which is what a security, what you need in order to value a security.

Fast forward and then I’m going to turn it over to Amy in just a second. This system, in my opinion, worked very well. The U.S. IPO market and capital markets were the envy of the world. We had very efficient systems.

Obviously, things changed and some securities went up; some securities went down. But we had generally a very well functioning security system. In the late ‘90s and early 2000s we had two events that changed everything.

The telecommunications industry, which had issued lots of IPOs because it was a very capital-intensive business, my firm Salomon Brothers with the famous analyst Jack Grubman, had been very bullish on some of the new entrants, the competitive local exchange carriers, the long-haul fiber companies. And effectively, many of those companies didn’t end up making it. And we had been very bullish on the industry. Jack Grubman, who was the analyst and very bullish, was banned from the securities industry.

Second, First Boston had led the IPO of a lot of telecom companies, including very successful ones, Amazon, Cisco, many, many others. But they also led the IPOs of a number of dot-com companies that ended up going under. And based on the losses for those two industries, the SEC came in and took a look at the research industry and decided there were conflicts and therefore that, in the future, research professionals could not be compensated with the advice or input from investment bankers and compensation could not include fees from investment banks.

And the result of that was that it was no longer profitable for firms to provide research on many of their

IPOs, particularly on smaller companies. And that changed the fundamental world. Instead of having 10, 11 or 12 companies providing research on an IPO, today you can often have just two or three.

In one name that I own in my portfolio which I won't name because there are disclosures involved, there was a spin-off from a much larger diversified company, a spun-off company that on its first day had a market cap of $700 million. One analyst, that analyst took his estimate from $2.00 to $1.25. The stock went from $30 to $10 today and the market cap went from $750 to $250. That would not have happened in the old world but it does happen a lot today.

So, with that I'm going to turn it over to Amy and then I'm going to come back and talk to you about why this is a problem.

MS. KROLL: Thanks so much, Charles.

So, Charles gave you a little bit of the historic background for why it is that we now operate with a pretty robust system of regulation and oversight of research activities. In the period that Charles mentions, as he said, the SEC did do extensive investigations and examinations, and then investigations of a number of investment banks. The largest banks, in particular, as well as, candidly, a few smaller banks. And did reach the conclusion that there were potentially pervasive conflicts between research and investment banking.

There were certainly some very exaggerated situations that were highlighted and you still hear about them in the press. I think that Henry Blodget has made it a second career based on his being the face of problems in the early aughts. But the bottom line is that the SEC, then NASD, New York Stock Exchange, as well as Congress all took action in the early part of the aughts. And we thought it would be helpful to just quickly walk you through that because it sort of helps to set the groundwork for some of the issues that are being faced today and being discussed today.

As I said, exams and enforcement actions, and can we switch to the slides? We did try to put a little bit of information together for you. Let’s see if this works. If not, I can read from the slides as easily as, okay. Yes, okay, the writing is too small. Our apologies. I’ll try to sum it up for you so I don’t have to worry about that. Headlines we can give you.

Exams and enforcement actions from 1999 to 2003 as well as rule making, Sarbanes-Oxley 2002 focus with regard to research on directing the SEC and the SROs to engage in rule making to address conflicts of interest. Actually, the rules were already under proposal at that point but, you know, how Congress likes to be sure to put its flag down when there’s an issue to tackle.

Regulation AC, the SEC’s regulation, directs broker/dealers, their associated persons, which are, in effect, affiliates that produce research and the research analysts to provide conflict disclosure with regard to the views expressed in research. So, if you’re familiar at all with research reports, there is always a certification paragraph at the beginning of the disclosure section where it states something along the lines of: I, then if fills in the name, certify that the views expressed in this report are my own and I wasn’t paid for these reviews.

If, in fact, neither of those statements is true, there’s an alternative certification that the Rule AC actually prescribes as well as some disclosure obligations. More importantly than Reg AC, because Reg AC has been a pretty standard thing since, it hasn’t changed since 2003, the FINRA, not FINRA, the NASD and NYSE rules which were also melded into FINRA rules have evolved. Initially, the rules were put out in 2002, amended in 2003 and 2004, again in 2008 there was a proposed overhaul. In 2015 there was an overhaul, at which point what had been rules applicable to only equity research and equity analysts were expanded to include debt research.

So, research as a whole is now pretty heavily regulated. There are enforcement actions brought against firms for inadequate disclosure in the research that they write. There are conflict issues that are addressed. There’s a panoply of disclosures required of conflicts, both involving the analysts and the firms with the companies, including whether the firm makes markets. Think about what Charles described about the functions that investment banks perform. If most firms agree that they will provide research and make markets in a company that they’re taking public, they cannot promise positive research, but they can state the facts of research.

There is pretty extensive controls on what analysts can invest in. And most importantly, coming out of the settlement most investment banks entered into, the ones that I mentioned, the larger banks, and the FINRA rules, interactions between research and investment banking are very prescribed. They’re controlled primarily by information barriers, physical separation, chaperoning in the case of firms that are subject to the Global Settlement as well as limitations on communications even for non-settling firms.

The one place where there is some latitude came in 2012 with the Jobs Act, a recognition that emerging growth companies needed a bit of flexibility. Companies did not want to have to have separate meetings with analysts and bankers. They wanted to get to know investment banks as a whole. So, the Jobs Act, among other things, imposed some limitations on the kinds of prescriptive activities that were inherent in the SRO Rules. And the one thing, though, that did continue is while an investment banker and a research analyst can attend a meeting together, analysts are still prohibited from participating in actually pitching an investment banking business and they are prohibited from being directed to go out and effectively market a deal.

And that’s for emerging growth companies, there is this latitude. And currently, based on the index, I checked, an emerging growth company is one with $1.07 billion in annual gross revenue. The statute talked about a $1 billion, but with every five year indexing, it turns out it’s now at $1.07, just as a factoid.

So, why are we talking about research? Charles explained that there has been a contraction in the level of research that covers small issuers. And, can you go to the next slide, please? And then I know that there is, you know, everybody is hearing, especially if you read, I find that the Financial Times has covered the issue I’m going to describe in a minute in some ways most attentively.

MiFID2 which was put into place by the EU in 2014 announced into effect in 2017 had, as part of its initiatives, a restriction on the ability of asset managers that were regulated under the MiFID regime to pay for inducements out of client funds. Inducements broadly defined include research and advice. So, what did that mean? That meant that starting in 2017 a manager regulated under MiFID could not pay what is called soft dollars, in other words, commission dollars; trading, couldn’t use trading revenue to pay for research; couldn’t use revenue that had been accumulated in, at least at the time there was a concern, in a Commission Credit Account, a CCA or a CSA. And, as a result, if a manager had to use hard dollars, which is money out of its own P&L to pay for research, payment to a registered broker/dealer would potentially have caused that broker/dealer to become an investment advisor.

There’s a carve-out from the definition of investment advisor that is for, I mean for broker/dealers, that allows for the provision of advice provided there is no special compensation. Anything that is non-commission dollars, non-mark-up dollars is deemed special compensation, hence a pretty simple, almost a Mobius strip. What does that mean? That means that a bunch of broker/dealers came to the SEC staff, to the Division of Investment Management and said, we’re about to be deemed investment advisors if we receive hard dollar payments from MiFID managers. And so --

MR. SOLOMON: MiFID managers, this is all institutional, not retail?

MS. KROLL: Institutional, and it’s institutional outside the United States primarily. MiFID is E.U. and U.K.

U.K. Brexit took place during this time, so Brexit, basically the U.K. has parallel provisions.

Anything else I have glossed over that you want me to clarify?

MR. SOLOMON: The only thing I want to say is, again, I want to make sure for the committee, I want to say that this does not impact people's ability to pay for commissions, or individuals pay for commissions all the time. This is institutions paying Wall Street firms hard dollars.

MS. KROLL: Institutions paying hard dollars out of their own P&L as opposed to using soft dollars, commission dollars.

MR. SOLOMON: Right, right.

MS. KROLL: I apologize. I get caught up in the minutiae sometimes. Thank you.

Division of Investment Management granted relief so that MiFID managers could pay in a way that would be compliant with MiFID, not be deemed broker/dealers, I mean not be deemed investment advisors. In 2019, that relief was renewed as well as some clarity that commission sharing agreements, commission credit agreements were acceptable ways to pay for research and not be deemed an investment advisor. Fine.

Why is this a topic today? Because that relief is about to expire. Over the summer the division director gave a speech saying the relief in those letters would be allowed to sunset and going forward, basically what that does is cause every broker/dealer that provides research on public companies to have to worry about this investment advisor status issue.

Now, that’s fine. Broker/dealers are big boys and girls. This is all in the institutional space as Jeff points out, at this point. Why are we worrying about this for small companies and for small company coverage? Let me say a few more words and then I’m going to turn it back over to Charles.

There have been some studies done, including by the SEC, probably contributed to the diminution of coverage of small issuers, is in fact, the MiFID restrictions. And, in fact, in the E.U. and in the U.K. both sets of regulators have now created carve-outs from the prohibitions on the use of commissions to allow for payment for research with client funds, with commissions for small-cap issuers. So, there is a recognition on the MiFID side that this is an issue, that there needs to be some inducement to increasing coverage, or at least encouraging more coverage of smaller companies.

Charles, you want to talk a little bit about this and why this is an issue for this committee?

MR. BOBRINSKOY: So, the core development is that smaller companies are moving from the public markets to the private markets. The company that I talked about that was spun off from the large diversified company that would have been a $700 million company in past years and is now trading at $2.50, what is going to happen is it's going to get bought up by an LBO firm. And the percentage of total investable capital in the Unites States that's in public markets trends down every year while the percentage that's in private markets, in buyout funds and venture capital trends up.

Why is that happening? It's all about cost of capital. If I have higher volatility, I have higher risk and I require a higher rate of return on an investment. If I have less visibility on what the earnings are of a company that I'm investing in, then I will demand a higher return, the cost of equity will be higher and the stock price, all else equal, will be lower. That is what we're seeing as companies move from what used to be the best advantage of the public markets, was a lower cost of capital.

LBO firms would sell their companies into the public markets because they could get a higher multiple which meant a lower cost of equity. That trend is now reversing and private equity companies are selling their companies to other private equity firms. And you all have seen the statistics, the number of IPOs, the number of public companies is shrinking. That's, I have to acknowledge my conflicts, that's not good for my business. I don't think it’s good for the country, as individual retail investors have less access to these exciting, growing companies.

A lot of individual investors have less access to LBO firms and venture capital firms than they do to a mutual fund like Ariel. But I acknowledge my conflict. This is tough on our industry because we can’t, because the securities that we invest in have a higher cost of capital, we are not allowed to have the same amount of research that a private equity firm can have. And this is a key point. All of the restrictions that Amy talked about don’t apply to private companies. A private company that wants to have a discussion with KKR or Blackstone is not subject to any of these restrictions. They can have all the research analysts in a meeting that they want.

So, this is a set of restrictions that only apply to public companies and increase the cost of capital and therefore decrease the value of equity. So, you know, obviously I think all of you on the committee are smart enough to know why increasing cost of equity is not good for companies. It’s not good for the formation of capital in the United States. It’s not good for our capital markets. We believe that more liquidity is one of the primary features of public markets. It’s why we have lower cost of capital than private equity, at least historically. And that’s under threat right now. And we would argue that it’s not in the best interests of our capital markets, although I acknowledge the conflicts of which I speak.

MR. SOLOMON: Before we open it up for questions, I want to frame one thing because this is super-technical. And I know when I'm in these committee meetings and there's a lot of technical stuff that goes on that I don't, like know about, it's hard to focus. Like, this is super-technical. But it's actually relatively straightforward from a recommendation standpoint, if that's something that we want to do.

So, I want to bridge a couple of things that are missing here because there's a couple of market conventions I want to fill in the gaps, if that's okay with you Amy and Charles, and with the staff.

MS. KROLL: That would be great.

MR. SOLOMON: Okay, so the issue is really one that when we went through that whole big slide on what's happened in terms of equity trading, it used to be that research was primarily, you could pay for research or produce research basically on your commission dollars that you got. And there were a lot of firms that just did nothing. They didn't even do investment banking. They just traded stocks. And commission rates were high enough that they could afford to actually have the infrastructure to produce research.

We can argue about the quality of that research, but there was more research objectively than there is today because there are more firms today who just traded equities having nothing to do with investment banking. This shift that occurred in the beginning of the 2000s made it less efficient. So, we went to pennies. We brought down the cost of commissions. I think we can all agree that there's a lot of good that happened. There's all that for individual investors. We do free commissions today. There's a whole different equity market structure.

All of that makes it so that you really, many firms can't afford to write a lot of research, you know, simply based on the commission dollars. They have to have other businesses that generate income that enable them to produce research. Layer on the fact that it's been a theme, and you'll see it in a letter we're probably going to submit here towards the end, the big get bigger and the small get smaller. And that's exactly what's happened in research, as well.

So, if you look at where the vast majority of trading occurs where there are commission dollars, most of that is in very large capitalization stocks and very little of it is in small capitalization stocks. So, if you were simply to try to build a business writing research on small capitalization stocks, it's very difficult given the expense associated with doing that, to write research if you’re only covering small capitalization stocks.

MS. KROLL: And this is an interesting corollary point, which is, again, this is from the SEC’s study on the impact of the diminution of research. Small cap companies have, on average, 1.9 firms covering them with research. Large cap companies have, on average, 10 or 11 firms, covering them with research. So, that’s --

MR. SOLOMON: So, there’s the empirical proof. That’s absolutely true. So, what does that mean? It means, and this is market convention, large cap research trading volumes subsidize the ability for firms to cover small cap names. Let me repeat that. If you’re not covering enough big cap names and generating enough commission dollars, you’re not going to have enough money to cover small companies.

And MiFID2, which is a non-U.S. rule, has crept onto our shores and made it so that it is more expensive to cover large cap research names because of the new rules in the compliance. The way that works is most of the big firms who pay most of the commission dollars adopt a compliance regime where they will comply with the most restrictive compliance regimes globally. So, when Europe rolled this out, that is the most restrictive compliance regime. MiFID2 is not a U.S. rule. But the creation of MiFID and all of the compliance associated with MiFID meant that all of the large global money managers, many of whom have huge portfolios here in the United States, adopted MiFID as the market convention.

The work-around, so that they could continue to pay U.S. firms hard dollars, so pay them actual dollars for research not commission dollars, right? Because MiFID says we don't want you using all your commission dollars for research. So, we want you to pay hard dollars for research and we want you to pay commissions for trading. That's what MiFID generally says --

MS. KROLL: And if you think, I always think of the best way to think about hard dollars as out of P&L, out of the advisor's P&L.

MR. SOLOMON: Or in some instances, many big firms just prefer to write Wall Street firms a check. And that check could be, it's just a commission payment in a check.

MS. KROLL: But that's okay. Commission payments in a check --

MR. SOLOMON: Right, that comes a couple different ways.

MS. KROLL: Yes, exactly.

MR. SOLOMON: So, all we're saying, the SEC basically has a rule that says if you're providing investment advice, that could be deemed receiving of a payment by an investment bank may be deemed to be an investment advisory --

MS. KROLL: An investment advisor.

MR. SOLOMON: Right.

MS. KROLL: If you receive special compensation.

MR. SOLOMON: Correct, and that will require a bunch of firms to adopt a brand new compliance regime that will insure that they are in compliance with the investment advisory rules in addition to the multitude of rules that they're already responsible for. Which is why I believe the SEC prior granted this exemption. And so, this is really just about insuring in many respects that it does not sunset, and I think that's what you're all basically saying; is that correct?

MS. KROLL: Well, there is certainly a view that it would be preferable for it not to sunset. I can't, I can't really advocate one way or another in this forum. I have colleagues who are advocating in other forums. I do think that there is a view, I can tell you that I am working along with colleagues of mine, we are probably working with 15 or 20 of the South Side firms that are trying to figure out how they are going to move forward with research after, you know, in a post-sunset world because, as Jeff said, they have to decide if they are going to continue to accept hard dollar payments from managers. In some cases, they really have to.

If they do, what does that mean? How do they deal with being subject to investment advisor status when writing research is inherently not supposed to be, it turns it into a fiduciary duty. I think that's a piece that we forgot. If you're an investment advisor, you have a fiduciary obligation to the recipients of your research. Thinking about fundamental company research as a fiduciary product is sort of a, almost like a clash of concepts if you take it to its most fundamental, but that is, in effect, what happens.

I think that, you know, there are firms that are going to find work-arounds. But I do think to Jeff's point, if that sunsetting were not to occur and that if there was a recognition that this construct doesn't make sense, that the future state construct doesn't make sense, it would certainly help take resources that are currently being devoted to trying to figure out how to deal with the situation and channel them elsewhere.

I would be remiss if I didn't say that the division has been very clear that legislative fixes would be perfectly acceptable to them. There have been some proposals. I'm not sure that they are, what their status is today, but that is one approach that the division has encouraged.

MS. GARRETT: Sue?

MS. WASHER: Yes, I'd just kind of like to bring this back to what the work of this committee kind of like by specific example. So, I for many years was just, we just sold our company in November. But for many years, I was a publicly traded company on the NASDAQ. And when we went our IPO in 2013, markets were up. Banks were making a lot of money. The biotech industry was up. And we had at our IPO, we had 11 or 12 analysts covering us. And we had five people on the cover of our S-1, which is kind of a lot for a small-ish company.

And then through the years, many of those analysts kept covering us. And then as the markets in 2020, 2021, especially, in biotech when down, banks on average were struggling. There were not a lot of IPOs. There weren't a lot of follow-ons. And so, we had analysts dropping off. And then several, two of the banks actually made a rule for their analysts that they couldn't cover anybody under $150 million market cap. So, they were just off. Whatever the analysts felt, they had no control over that. It was just a rule.

And then we had companies that we had not put back on our cover during our follow-ons because we had so many banks we were working with, wonderful for us. But we had so many banks we were working with, we couldn't put 12 banks on the, on the cover of an offering. So, we were trying to rotate through the different banks and give them pieces of our business trying to make everybody happy. And some of them weren’t so happy with that. And so, they said we’re going to drop coverage on you unless you pay this, pay us this separate financial services fee.

So, basically they were asking us to pay to maintain research coverage which is, I think, I know a lot of my peers have heard the same thing. And so, I think this is a unique problem as Jeff just pointed out to small companies and we’re all living it out there. Because the moment you can’t tell investors and rattle off your analysts and what banks they work for, the investors lose interest because they have nowhere to go to independently ask questions. And so, I think this is a significant, real problem for small publicly traded companies.

MR. SOLOMON: Just to tag onto what she said. I mean, I can’t imagine ever having that conversation with a CEO, but I know other people do. I think this is sort of in the unintended consequences category. There’s a great regime here for the SEC with all the rules that we saw to observe. And there’s a great, you know, a lot of the work that was done in the early 2000s that led to research independence is working fine. There’s a lot of internal controls that we put in place from a chaperoning standpoint and firewall standpoint to insure we’re audited by that.

The SEC comes in and takes a look at it. FINRA comes in and takes a look at it. We are assiduous in that. And I think that's exactly what the SEC should want, all firms to be engaged in that kind of behavior. What this will ultimately end up doing if it doesn't get, you'll see a lot more activity like this where you'll get much more conflicted research, where people will pay, companies will pay for research that's not exactly objective or independent.

Worse yet, people will begin to look in other places for research like the chat boards and the Reddit boards and we already know what happens to individual investors when there's a lack of information from the regulated entities. However, conflicted people may think it is, it is highly regulated and it is thoughtful, for sure. And when you're looking at, you know, certain individuals who have great social media presence, who think that they know a lot about the stock market, they start to post and write up boards, they create their own followings, that is not regulated. And we end up in a situation where that's where individual investors go for information really detrimental.

So, it seems that this is a relatively straightforward fix to keep research inside the regulated envelope from a regulation that wasn't even intended for the United States. And so, this is, I think, what we're really talking about. Sorry.

Bert?

MR. FOX: Two questions and these are probably into devil’s advocate type questions, just because I’m trying to seek to understand. One is, let’s say you go back to increase the TICK sizes or something else, right? How are you going to do it? How is there a guarantee that the research will actually get funded? So, that’s question one.

And then two is, to Sue’s point maybe the alternative view is, is that if this really would, you know, lower a company’s cost of capital and have all these benefits, why wouldn’t a company eventually want to pay for it out of pocket? I understand. I’m just saying, like if there’s actually all these benefits that would occur to the company, it wouldn’t actually be in their best interests to pay for it. I get your point, Jeff, but that’s a flawed model in terms it’s even more biased. I’m just trying to understand. I mean, I understand there’s a lot of thought about this, but are we actually, truly convinced that this does actually have all these benefits?

MS. KROLL: I would say that I don’t know a CEO that would want to pay a research analyst for research because then, once that’s known, everything that research analyst writes is, is discredited no matter how good they are. And so, it’s kind of like bad money down the drain.

MR. FOX: Just hypothetically, assume we

could get over the conflict, I’m just trying to say, you know --

MR. YADLEY: Can I ask a follow-up question? So, and I get that, but so what if it’s biased if it’s disclosed? Because the broker still has duties, I mean.

MS. WASHER: No, the investors won’t believe it, though. It doesn’t, from my company, I want investors to believe the information they’re being given or else it’s detrimental information and then they’re not going to buy my stock.

MR. FOX: But that’s overly cynical then. I think you’re then assuming that brokers have no honor at all. And they are regulated. And they do have fiduciary duties.

MS. KROLL: No, they don’t have fiduciary duties. And that’s --

MR. FOX: I thought you said when they do research --

MS. KROLL: No, no, what I’m saying is --

MR. FOX: The investment advisor --

MS. KROLL: If you fall into an investment advisor, then you suddenly have a fiduciary duty. Do you want the entity that is writing what is supposed to be independent research to have a fiduciary duty? Now, I will say to Sue’s point, that is not what will happen. Well, it might be actually, if you're paid by a company hard dollars to write research, that's still not commission dollars. So, that's special compensation. This will cause that broker/dealer to be an investment advisor, to have a fiduciary duty perhaps to the company even though the advice, the advice is going out to the public. That creates a whole new set of issues. So, that's one thing.

Go ahead.

MR. FOX: Just back to my original, sorry, hypothetically a bunch of smart minds get together and completely overcome the conflict issue. I'm just trying to get to my question is one, if it's paid through soft dollars are we actually convinced that they'll actually the research. And two, is there really enough research that truly says that is has enough impact on the cost of capital?

MR. SOLOMON: I think a couple things. So, first of all, I don't think we're ever going back to eighths and quarters. So, it's never happening. There's a whole bunch of reasons why it shouldn't, by the way. I'm not advocating for it. I don't think you can. I think we've talked about TICK size at various points of time. I'll let, I'll let the division of markets figure that out. That's not for this purview.

I think the issue is really more of whether or not it's, again, increased regulation that forces increased costs and makes smaller players decide to, it’s not economical for them to cover research. So, I don’t think you can draw a direct line between, like hey, I’m getting this commission so I’m going to pay your research as aggregate revenue dollars and how you choose to spend those revenue dollars. Listen, again, we’ve our own personal experiences at Cowen. You can write independent research at scale and grow meaningfully and grow your commission dollars meaningfully. So, but I don’t presume just because we figured out how to do that that there will be a lot of people figure out how to do that.

It was really hard. We suffered a lot of slings and arrows. Our investors repeatedly told us we were investing in businesses that would never make any money on it at all. But we did it and we did just fine. I just don’t think that is, when you talk about the public good for having more information from regulated entities where the rule set mandates the behavior that the SEC and regulators and legislators have tried so hard to actually create. Like we can’t be casual about these things at all.

And so, my view is we should have more people, more firms focusing in particularly on smaller companies where it’s the hardest. And so, adding more logs to the fire to make it less economical or more onerous to write that research will simply perpetuate less research in regulated entities where we can observe that behavior. I think people will write what they write and they'll write wherever they want to write it. From our standpoint, if I look at it through the eyes of investor protection, you want reputable firms, highly regulated reputable firms to be writing research on big companies and small companies as much as possible.

And so, we should, we should really think about whether or not adding something or not doing something that inhibits that behavior actually benefits anyone. And I would argue that it doesn't, but I think that's for debate here.

MR. YADLEY: And that's what I was trying to ask is that I wanted the research to be written by people who are regulated. So, what we're saying is that the impediment that we're looking at now is the sunset of this exception, right?

MS. KROLL: And so, to make a, bring it full circle for you, there is a category of unregulated entities that are writing research and I want to mention that after I respond to your question. But what Jeff is talking about right now is highly regulated entities that write research today. With the sunsetting of this relief, the no action relief, at least a significant part of the payments for the research, which today is now coming in as hard dollars, P&L, other forms of non-commission dollars, would cause an additional layer of regulation which doesn't really make sense when the goal is fairness of the market, independence of research, investor protection.

It would make sense if this was an already lightly or unregulated venue. The reason I mention there is a category of what are called independent research providers. Not the firms that get paid for research. There are some of those that are independent research also. Some of the firms that Sue was referencing actually are registered broker/dealers. They've come up with a model.

But independent research providers are often firms that have been created by folks who left broker/dealers because they didn't like all the regulation and they went out and said we are just independent. We are not investment advisors. We are not broker/dealers. And they get paid in lots of different ways. They get paid commission dollars. How do they do that without being a broker/dealer? They get paid those commission dollars out of CCAs and CSAs based on some no-action relief that said as long as you don't do anything else that a broker/dealer does you can get paid if you're an independent research provider.

And that's in the context of another set of regulations that colloquially are referred to as Section 28E having to do with fiduciary obligations. Independent research providers also get paid subscription fees or hard dollar payments. Now, why doesn't that cause them to be investment advisors? That's a very good question. Most of them will say because we're not investment advisors without having actually done the analysis.

And then there's sort of a sub-sub-group, which is just people who never talk to investors, never do anything other than publish, publish, publish. And then they rely on another exemption called the publisher's exemption. So, there is a category of unregulated entities that do produce research and get paid for that research but that's not even the universe that Jeff is talking about today. He's talking about highly regulated.

MR. SOLOMON: And most of that research, to be fair is not independent SOC research. So, a lot of it is macro-economic research or big FEME research, it's not specifically geared towards, let's say, you know, the biotech industry or names in the biotech industry and/or any small companies. It's this small company research, just a very few independent firms. There's some, but it's very few who wake up and say, hey, I think I can make a decent living just doing small company independent stock research. I can't actually think of any. But I'm sure they're some.

MS. KROLL: I've been stunned over the years to realize how many. It's always populated by folks who used to be highly regulated, you know, registered research analysts.

MR. SOLOMON: So, I think, you know,

again, what we're talking about here is two things. One is the sunset provision. The other is, again, this idea of all of a sudden elevating, you know, Wall Street research to a fiduciary standard. Again, anytime you increase a standard like that I think everyone looks at well whether or not, you know, what's my increased liability?

So, it's not whether or not you can actually charge for it. Now, all of a sudden if a research analyst writes something and they're wrong, which, you know, shockingly happens, you know, did you breach, now we're going to be looking at whether or not that research analyst breached some sort of fiduciary responsibility.

And if they get tentative about publishing because they might be wrong, then maybe they won't be published. And certainly the riskiest people to write research on where you're wrong the most often would be the smallest companies because that's who's the riskiest companies. Oftentimes you might have a view and stuff happens. And so, when you just look at the risk associated with writing small company research versus writing large company research, the risks are greater.

MS. KROLL: Especially because one of the required disclosures after a year of coverage is percentage of buy, percentage of hold and percentage of sell ratings assigned to the research you cover. So, that contributes to some of that, as well.

MR. SOLOMON: I said I wasn’t going to but I did, sorry. Any other questions or thoughts?

Charlie, anything you want to weigh in on? Thank you for doing this.

MR. BOBRINSKOY: Yes, I just want to remind the panel there are lots of industries in which the issuing companies pays for the research. In the world of bonds, it’s the company that pays S&P and Moody’s. Everyone knows that but it would be impossible to have bond buyers pay S&P and Moody’s for the thousands of securities that they invest in. There are lots of other examples where I would argue it’s not a conflict. It’s a virtuous circle.

You know, if I go into Home Depot and I don’t know anything about saws, I take some solace from the fact that Home Depot’s buyer bought that saw. And if he recommends a saw that doesn’t end up working that well, it’s bad for his company. And so, that’s the system that keeps him in line and the recommendations that he makes to me. So, I still think that system works. It’s got a very important set of penalties.

If somebody gives bullish research on a company that goes bad, I promise you there are lots of mechanisms in the market that punish that research analyst. And so, I do think that these restrictions on compensating research have been bad for the market for small cap stocks and anything that would add to those restrictions and costs would be something that would be painful for me and my investment businesses buying small cap companies.

MS. MEHTA: Can I ask --

MR. SOLOMON: Greg and then Sapna.

MS. MEHTA: I saw on the slides that the reason it’s not, the sunset provision is not being continued is that the SEC thinks that there has been ample time to sort of digest these rules. Can you talk a little bit about how they think this is going to play out?

MS. KROLL: I actually, that’s a hard question to answer because the statements that were made were that there had been examinations but we have not necessarily seen any evidence that there were exams. There are some firms that for business reasons that already had investment advisors have moved aspects of their research into those investment advisors for when the company, the broker/dealer is paid in hard dollars. So, they’ve effectively now got dual track. The same research is going out on the broker/dealer track as an investment advisor track. And we know that from talking with participants in the industry.

That doesn’t seem a very efficient way, but it’s at least a way of doing it. And our understanding, there have been some articles written over the last several years talking about firms that did take this step. What I can tell you is, it's imperfect.

We haven't actually found a firm, and we represent a lot of broker/dealers and investment advisors in our practice, that has found the golden mean for making this actually work perfectly. One of the issues once you are an investment advisor, whether you're a registered investment advisor or not, there is a prohibition on principal trading without trade-by-trade permission from advised clients.

So, for instance, think about a firm with active market making. If their research is going out of an investment advisor, then the, any trade in the name of the research by a recipient of the research probably can't be effected on a principal basis unless the client gives approval, which kind of doesn't make any sense in the world we're talking about. That's one of the struggles that, now if you don't make markets, a firm doesn't make markets and only trades on any agency basis, it doesn't have that issue.

So, to answer, I'm answering the question scattershot because there has not been a report put out. There has not been anything that has empirically established that a series of exams validated that the problem has been solved. It is true that the problem has been around not only since 2014, but this is a problem that has, a problem existent prior to, but it's been highlighted certainly in the last number of years. But the reason that nobody has found a perfect solution yet is, as best as I can tell, there isn't one.

MS. GARRETT: Thank you, Amy.

Commissioner Uyeda, did you have some words to say?

COMMISSIONER UYEDA: Well, thank you.

You know, this has been just a terrific discussion. I wish there were more of these around the Commission. The reason why I say that is, what makes this so complicated is this really involves all facets of what the SEC does. And it's so crucial. When we think about the whole ecosystem for the equity markets and the fixing for that matter, it revolves around information and how information goes into setting the price discovery process. And one of the things that makes this so difficult, not so much difficult but, I think, complicated is this really covers all facets of what the Commission does and it's not owned by one division.

Smaller public companies, that's overseen by the Division of Corporation Finance. The advisors at issue is covered by the Division of Investment Management. And so, now you raise why does the SEC think the problem has been resolved? I can clarify that that's the views of Director Birdthistle and in terms of his no action request, this has not been evaluated by the Commission. It's been something that I've actually been calling for. And then, but before I get to that, it’s when you look at Reg AC, the obligation to broker/dealers, the oversight of FINRA and what FINRA is doing on this, that’s all our Division in Trading and Markets.

And one thing you learn in Washington is the fastest way not to do something is to say we need to decide by joint task force or joint project between multiple divisions or agencies. And it, you know, and I think it was in 2020 in the Consolidated National or National Defense Authorization Act, Congress asked the SEC to do, write a report on research analysts and what it had done. And I was a detailee to these from the SEC to the Senate Banking Committee when that came up. I was somewhat disappointed. It was a nice factual tome but it really didn’t analyze the --

MS. KROLL: It did ask a lot of good questions. It suggested needed to the committee to be explored.

COMMISSIONER UYEDA: Yes, it did that, but it really didn’t provide any thoughtful here is what has developed, especially since 2023 and that, I’m sorry, 2003, when we had the Global Research Analyst Settlement. And one thing that talked about is the need to go back and do a retrospective review of our rules but that applies to the same things as the Global Research Settlement and the practices and developments since then. And this takes a lot of looking but I think it’s, you know, again in my views individually as a Commissioner, it’s what we shouldn’t be shying away from.

We’re doing an awful lot of things in a lot of different areas. But this, what you’re talking about today I think is just so fundamental to the operation of the markets and it’s disappointing that it is not on our regulatory agenda that we’re not doing something further. So, that’s a long way of saying that’s what makes what you’re doing today and your recommendation so much even more important, because right now you are, this is sort of the latest and greatest effort that’s been thinking about research analysts and it’s something that, that I take very seriously. So, thank you and I really appreciate the discussion today.

MR. SOLOMON: Well, first of all thank you for saying that. I think it’s probably a great way to encapsulate the efforts. We should probably talk about whether or not we’re willing to engage in sort of a thought on this, on a recommendation. You know, again, I think it’s, we started some pretty big topics earlier. Maybe that was the whole point, to winnow it down to something very specific. At least in this last session, it’s a very specific.

And, you know, if we’re making recommendations, I think at a minimum we should recommend to the Commission that this particular provision not sunset, that it be extended and that more work can be done to take a look at Commissioner Uyeda’s, you know, request that more work should be done to holistically take a look at what we’re doing to improve research and research capabilities, particularly for small companies, but really taking a retrospective and looking back at how the situation in research has progressed since 2003. To maybe make more holistic recommendations that accomplish both investor protections as well as better and more highly regulated information flow coming from, or more accurate information independent coming from highly regulated firms which would be putting us all in a much better place. You know, it’s just if we can get a general consensus on that then we can draft something up and send it around.

COMMISSIONER UYEDA: I mean, it sounds like a long-winded way of saying do no harm, right?

MR. SOLOMON: Yes, that would be long-winded. That would be my middle name.

COMMISSIONER UYEDA: I’m just saying it’s, and I agree, I mean, I’m not sure I would, I can know what the right answer is, but it seems like not sunsetting until more work is done makes a lot of sense to me. So.

MR. SOLOMON: Sorry, say that again? So, again, there’s been a few things. There’s been a lot of comments on this in the public domain. I don’t want to necessarily plagiarize from other, other organizations that have made similar statements.

Greg, did you have something?

MR. DEAN: Yes, I just want to say that it’s a good discussion on this, especially coming, I am from FINRA, so we do have a role within this, within the SEC in the Global Settlement that happened 20 years ago. And the reasons for that happening are quite clear. But there are also good reasons to operate within the regulating system itself. And I think that’s where we’re seeing there’s a lot happening in the unregulated, unlicensed space where there may be legitimate research that’s taken and bent out of ways.

As I mentioned earlier, our National Financial Capability Study is showing that 60% of younger investors are using social media and others to get their information for investing. That could be very troubling in how that information is derived, used. And so, coming up with a recommendation within the regulated space to help promote that does help, as the Commissioner said, the price discovery mechanism. And it helps to keep, where you are keeping the bad actors out.

MR. SOLOMON: So, again, I, not to be long-winded, I think that’s fair. I think we should think about crafting something specifically that recommends that we don’t sunset and that we go back and take a look and do a retrospective a little more deeply at how can we repair the research ecosystem at the SEC to promote more small company research using and citing maybe the SEC’s own analytics on it and come up with better proposals holistically for improving the situation around small company research.

Does that, does everybody want to --

COMMISSIONER UYEDA: Yes, second that.

MR. SOLOMON: Yes, great. All right.

MS. GARRETT: Let’s just do a formal vote. All in favor?

(Chorus of ayes.)

MS. GARRETT: Is anybody opposed?

(No response.)

MS. GARRETT: Okay, thank you.

And thank you for that discussion, Amy, thank you very much. And thank you, Charles.

MS. KROLL: Thank you for having us.

MR. BOBRINSKOY: Thank you.

MR. SOLOMON: This is it. This is your swan song, Madam Chairwoman.

MS. GARRETT: No, no, no. This is just a, as I mentioned this morning, this is the last Advisory Committee meeting for many of us. And before we get into the swan song, I do want to say that we shared a letter earlier with parting remarks. And I welcome feedback from this committee on the letter. I wanted to see if people had feedback on the letter or if people had comments?

Sara, yes?

MS. HANKS: What I said this morning, one of the things I'd like to do is add references to all of the other recommendations of the other incarnations of predecessors to this committee, much of which was entirely consistent if not repetitive, and just emphasize that so many of these things we've been saying for quite a long time.

MS. GARRETT: Okay, thank you.

MR. SOLOMON: I would accept that. As you know, I think the finder's proposal and the private placement broker issue is a really important one. And I think it's easily addressed. And we've commented on that before. So, if the sense of the group is to do what Sara said, then I think that would include that.

MS. GARRETT: Right, for the people that might not know, there was a predecessor committee to our committee. Both Sara and Greg and others served on, Catherine, served on that committee. And that committee made a number of recommendations at the end of their terms. And some of their recommendations are the same recommendations that we are making now.

And so, what I think they're trying to point out is that we've been making some of these same recommendations for many, many years, for instance the finder's recommendation and the private placement recommendation. And so, what we would be doing is linking in our letter that we drafted a reference back to the predecessor committee recommendations.

Does anybody else have any comments on the letter?

Yes, Bert?

MR. FOX: Well, two comments. One, the part about where it says make it easier for companies to go public. I'm trying to recall because some of those were the earlier discussions that we had. I find a lot of our discussions focus as much on not having, if you will, regulatory arbitrage in favoring private markets over public markets and not just making it, I don't know if I want to create that make it easier to go public is a, all of a sudden is an easier path to capital. I think it just should be, it's one of the paths to capital, right?

And so, the fact that that's first struck me as, you know, because I think we talked just a little bit about not having this huge regulatory arbitrage, right, in terms of a private market is much more favorable to a public market. But maybe I'm mis-remembering that.

And then for, of the small funds, and even to the discussion today, maybe an encouragement for future incarnations of this committee to study that more, as well?

I think we're encouraging the Commission to support rule-making, but I'm not sure we've really scratched the surface. I think we've scratched the regulatory surface, right, but not some of the other surfaces on what some of the other barriers to starting a fund are, right? And how do you do it? What does that look like? And that may be fertile ground for future committee meetings, right? And, you know, putting that out there, as well.

My two cents.

MS. GARRETT: Thank you.

Does anybody else, Sara?

MS. HANKS: Just one item about the, I keep losing it because it's so hidden away. The efficacy of, improving the efficacy of Reg A and others by addressing secondary market liquidity concerns. I just thought that sentence was a little lost and might be better inserted in the third paragraph in the first, the third section in the first section, because it's more of a, you know, making it easier to go public and attract capital. And if it could have its own paragraph because it is important. Liquidity is a very important aspect of the capital raising.

MS. GARRETT: Okay, thank you. And we might, based on Bert's comment, change the order of some of the paragraphs, but we would put it under that heading and in its own paragraph.

Anything else? Okay, then I guess I'd like to take the approach on whether you would like to vote in favor of adopting these recommendations in this letter to go to the Commission.

And all in favor?

(Chorus of ayes.)

MS. GARRETT: And anyone opposed?

(No response.)

MS. GARRETT: Okay, well, thank you very much.

I do have a few parting remarks. I'm sure Jeff does, too. His will be more sentimental. Mine will be a lot more thanks.

So, first, I just want to say I applaud the Commission for establishing this committee where capital formation issues that are unique to small businesses can be identified and addressed. I thank all of the committee members who've served on this committee, not just today but over the past four years for all of the work that you've done on the committee. It has been a pleasure working with all of you and getting to know you. I love your diligence in attending the meetings and working with recommendations, on working together. I also know all of your day-to-day work that you do in this area and this space and, you know, have been, just loved working with all of you.

I thank my Vice Chair, Jeff Solomon, for his immense knowledge, our great partnership and his ability to always make a meeting a thousand times more interesting than it otherwise would have been.

I would like to send a special thank you to the staff of the Office of the Advocate of Small Business Capital Formation. The work that you do in your office has been a tremendous help in our committee. Also, I am in awe of all of the resources, data, and awareness that your office has created in the past four years. It is invaluable to small businesses seeking to obtain capital. Most of you know, but if you don’t, their office was created just before our committee was created. And so, all of the work that they have done has been done over the past four years and I believe that it is very, very beneficial to small companies.

As maybe it was Greg or somebody else pointed out today, people can get a lot of information about how to, you know, work their way around the securities regulations because of all the work that you guys have done. That’s a tremendous resource for small businesses. So, thank you very much. I will very much miss working with you guys. And I admire you guys for everything that you’re doing on the day-to-day basis. We do this as a part-time job. You do this as a full-time job. So, thank you very much for that.

Finally, it has been, you know, my honor to serve as the Chair of this committee for the past four years. And it's been an amazingly rewarding experience. I hope that, I hope that some good has come from it. And I want to thank former Chairman Clayton and Chair Gensler for permitting me to serve in this role.

Jeff?

MR. SOLOMON: I'll try to be brief. It's hard. I think to echo everything you've said, I think this has been one of the more special engagements that I've had, you know, in my career. It's really been mostly about the people, the people around this table, all the prep meetings, the staff because we're all doing this, mostly, with the exception of staff, we're all doing this because we feel passionate about helping others. And the success that we've been able to accomplish in our lives is a function of so much of the success, of the people that we're helping, right? And I just think that this has been a phenomenal opportunity that the SEC has afforded us, that Chairman Clayton and Chair Gensler have afforded us the opportunity to pay it forward in many respects.

And I think all of us came to this committee with the idea that we could be helpful beyond what we do in our day jobs. And you just don't find that, you know, I just don't find that very often in our careers that we get the opportunity to do something that really has broad-reaching impact that extends beyond what we do on a day-to-day basis.

So, I just want to thank each and every one of you for enriching, you know, my life and our lives and just the things that you're doing in using this as a forum to create better change. There's been a lot of discussion about a lot of things in this committee that went way beyond small business that I think has just opened up my mind and opened up all of our minds of ways of thinking differently about different aspects of our society. And we did this through a very tumultuous time in our country's history and global history.

And we've come out the other end of it stronger, better and I think more focused on the things that matter most to insure that this great country of ours is more inclusive and more effective for more people. The idea of benevolent capitalism can work. It needs a lot of work. It needs people who care deeply about it. And for us, and we talk about this a lot in our prep calls, this is a way for us to insure that what we're doing on our day jobs has broad reaching benevolent impact beyond just the dollars and cents. And for that, I just, you know, I'm grateful.

The only other person I would like to thank other than the staff specifically, and I'm sad she's not here but I'm sure she's on the webstream, and that's Martha. You know, I just don't know what it would be like to stand up an organization like this inside the SEC. You know, and I don't think I ever saw her complain one time about it. I'm sure there were lots of challenges that we didn't even get to see.

But the truth is that the effectiveness to the extent that we impact things, and I think we have, the influence that we've been able to have is a function of the fact that she took up the mantle as the initial course by Sebastian, who's done an amazing job and the rest of the staff. But if we, we can't go an entire day today without mentioning the work that Martha did and she continues to do in her new job. And I know if she were sitting here, well, wherever she's sitting, I'm sure she's beaming and she's proud to see that the work she started continues.

And maybe that's the best way to end this. I think as we hand it over, all of us that are leaving, to the next generation, don't give up the fight. Fight hard for small business. Fight hard to do the right things. Fight hard to protect those that deserve to be protected and included. And don't lose sight of the fact of what we're doing here in this committee matters to so many people. And if we do that, then I think that all of the good work that we've done over the last four years will be so worth it. So, thank you for the opportunity.

MS. GARRETT: Thank you.

MR. SOLOMON: And of course, to the Chair. She’s great and a great partner and it’s been amazing. You and I are going to have to talk lots about a lot of other things because I just will miss the regular rhythm with you. So, I look forward to continuing.

MS. GARRETT: Yes. And thank you, guys, for today. Today was a tough day. We had a lot of really meaty conversations on the table and we were able to, I think, address a lot of issues. And so, thank you for working with us on that. And, on that note I will move to adjourn the meeting and say goodbye as Chair.

MR. SOLOMON: Good-bye.

(Whereupon, at 3:22 p.m. the meeting was concluded.)

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PROOFREADER'S CERTIFICATE

In the Matter of: SMALL BUSINESS ADVISORY COMMITTEE MEETING
Date: Tuesday, February 7, 2023
Location: Washington, D.C.

This is to certify that I, Christine Boyce, (the undersigned), do hereby certify that the foregoing transcript is a complete, true and accurate transcription of all matters contained on the recorded proceedings of the investigative testimony.

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(Proofreader's Name) 2-13-2023

REPORTER'S CERTIFICATE

I, Stuart Karoubas, reporter, hereby certify that the foregoing transcript of 181 pages is a complete, true and accurate transcript of the committee meeting indicated, held on February 7th, 2023, via WebEx Virtual Hearing regarding: Small Business Advisory Committee

I further certify that this proceeding was recorded by me, and that the foregoing transcript has been prepared under my direction.

Date: February 13, 2023

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