September 27, 2021

Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: September 27th meeting of the Small Business Capital Formation Advisory Committee

Dear Ms. Countryman:

The American Securities Association[1] provides these comments for the scheduled September 27th meeting of the Securities and Exchange Commission's (SEC) Small Business Capital Formation Advisory Committee. (Committee) We appreciate the Committee's attention to capital formation issues and its timely discussion and analysis of the initial public offering (IPO) market.

The ASA has been a leader in providing recommendations and working with the SEC and Congress to help small businesses raise capital and make it easier for companies to go and stay public in the United States. In 2018, the ASA helped publish an inter-organizational effort to produce over twenty recommendations for Congress and the Securities and Exchange Commission (SEC) to improve the public company model in the United States.[2] (IPO Report)

The ASA has long been concerned about the decline in the number of public companies over the last two decades, and the regulatory disincentives to go public that still exist for growing companies who need access to the public markets. We also remain concerned that companies are tending to go public much later in their lifecycle, and that while these large companies may benefit from recent trends such as direct listings, the IPO process still remains inhospitable to young, small companies that need public capital to grow. Having these companies enter the public markets earlier in their growth life cycle would also enable mom-and-pop investors and retirement savers to share in their success and growth their wealth.

[1] The ASA is a trade association that represents the retail and institutional capital markets interests of regional financial services firms who provide Main Street businesses with access to capital and advise hardworking Americans how to create and preserve wealth. The ASA's mission is to promote trust and confidence among investors, facilitate capital formation, and support efficient and competitively balanced capital markets. This mission advances financial independence, stimulates job creation, and increases prosperity. The ASA has a geographically diverse membership base that spans the Heartland, Southwest, Southeast, Atlantic, and Pacific Northwest regions of the United States.
[2] Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public, available at: https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/05/CCMC_IPO-Report_v17.pdf

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While some of the recommendations included in the IPO Report have been implemented, there are several unresolved items we believe Congress and the SEC should prioritize. There is a history of bipartisan agreement to advance capital formation reforms. The 2012 Jumpstart our Business Startups (JOBS) Act has been a success for both public and private businesses as well as investors, and in 2018 the House of Representatives passed the JOBS and Investor Confidence Act by an overwhelming bipartisan margin.[3] The partisan divides that define many issues generally do not exist when it comes to capital formation.

One of the economic bright spots since the onset of the pandemic has been a surge in business startups. A recent study found that Americans created 4.4 million businesses last year, an increase of 24% over 2019.[4] While this data shows that the American entrepreneurial spirit is alive and well, these new businesses will need capital if they are to survive and contribute to the next wave of American growth and innovation.

We also believe that access to capital must be balanced with adequate investor protections. Creating regulatory loopholes that allow bad actors or questionable businesses to dupe investors will only cause harm to the most vulnerable in our country and undermine confidence in America's capital markets. To that end, ASA has been concerned over the rise of "direct listings" for primary offerings and have also provided recommendations related to special purpose acquisition companies (SPACs).

As the Committee considers further reforms to improve the IPO market, the ASA makes the following recommendations:

Improve Research Coverage for Pre-IPO and Small Public Companies

One of the more troubling developments in the public markets over the last two decades has been the collapse in research and analyst coverage of small issuers. Recent data shows that as many as two-thirds of companies with a market cap under $100 million have no research coverage at all.[5] While the shift towards index investing and away from individual stock selection may play a role in declining coverage, there are several regulatory issues that have contributed to this decline which should be addressed.

The ASA has previously called for the SEC to conduct a holistic review of this decline that will lead to policy recommendations that will help to increase analyst coverage of small public companies.

[3] S. 488, 115th Congress
[4] Surge in start-ups is a surprise in the pandemic economy, New York Times (February 17th, 2021) Citing research from the Peterson Institute for International Economics, available at https://www.nytimes.com/2021/02/17/business/pandemic-entrepreneurs.html
[5] CapitalIQ as of June 9th, 2017

Potential reforms include:

- **Broker-dealers should be permitted to receive hard-dollar payments for research from clients without having to register as investment advisers.** Since the implementation of the EU's Markets in Financial Instruments Directive, there has already been a steep decline in the number of research analysts employed as well as the number of companies covered. There has also been a trend towards coverage of larger, more established companies at the expense of smaller ones, which further exacerbates the difficulties that small companies have in accessing the capital markets.[6] In addition to depriving money managers of valuable research, the continued decline of company-specific information in the marketplace can further accelerate the trend toward automated and passive investment strategies. While the SEC has issued limited no-action relief to allow broker-dealers to receive hard dollar payments for research, a permanent solution is necessary so that the drop in research coverage is not further exacerbated.

- **Rule 139 under the Securities Act of 1933 should be amended to permit broker-dealers to continue research coverage of issuers without such coverage being deemed an offer or sale of securities.** Currently, such a safe harbor only exists for issuers that are Form S-3 eligible, and not for smaller issuers including emerging growth companies (EGCs).

- **The SEC should produce a holistic report and recommendations to improve research of pre-IPO and small public companies.** The ASA strongly supported the Treasury Department's previous recommendation for such a review and believe that a comprehensive review of the 2003 Global Research Analyst Settlement as well as SEC and Financial Industry Regulatory Authority (FINRA) rules should be conducted. While there have been rule changes made to encourage pre-IPO research, without a liability safe harbor it is unlikely that we will see a meaningful increase in pre-IPO research. Bipartisan legislation, the Improving Investment Research for Small and Emerging Issuers Act, has already passed the House of Representatives on two occasions.[7]

Secondary Market Trading Reforms

Little has been done to improve the secondary market trading environment for small issuers. The SEC has missed several opportunities to implement reforms that have the longstanding support

[6] See e.g. Research Analysts' Existential Crisis Enters MiFID II Era (Bloomberg) January 3, 2019, available at https://www.bloomberg.com/news/articles/2019-01-03/the-research-analyst-s-existential-crisis-enters-mifid-ii-era; Why MiFID II Isn't Working as Intended and Investors are Losing as a Result (Melius Research) December 6, 2018, available at http://www.integrity-research.com/mifid-ii-isnt-working-intended-investors-losing-result/
[7] H.R. 2919, 116th Congress

of a broad spectrum of market participants. This failure to act has effectively kicked the can down the road on the market structure debate, preserved the status quo for those who benefit from the current trading regime, and continues to be a disincentive for growing small American businesses to complete an IPO. Congress and the SEC should take this as an opportunity to reset the market structure debate and prioritize reforms that support small business capital formation and market stability.

Potential reforms include:

- **Suspending unlisted trading privileges (UTP) for small issuers with distressed liquidity.** UTP enables securities listed on an exchange to be traded on other national securities exchanges and is automatically extended to securities prior to their listing on an exchange. While UTP makes sense for larger companies with adequate liquidity and significant trading volume, it simultaneously fragments liquidity and increases trading costs for thinly traded stocks, which tend to be smaller issuers. The IPO report recommended that issuers with distressed liquidity be given the option to suspend their UTP, and Congress has also recently weighed in on this issue. In July 2018, the U.S. House of Representatives passed the "Main Street Growth Act," which would create the legal framework for venture exchanges in the United States. Included in that legislation (which had earlier passed the House Financial Services Committee by a vote of 56-0) was an important provision that would prohibit venture exchanges from extending UTP to issuers that chose to list on a venture exchange.[8]

- **Permit certain issuers to determine their own intelligent tick sizes.** The IPO Report also recommended that issuers become eligible to determine their own "tick-size" to improve the liquidity of thinly traded or lower priced stocks. The SEC's 2000 decimalization order transitioned the trading of stocks – regardless of stock price or market capitalization – to penny increments. While decimalization may make sense for large capitalization, highly traded stocks, narrow trading spreads can serve as a disincentive for market makers to trade the shares of EGCs or other small issuers. A 2019 report from Nasdaq, done in collaboration with a diverse group of market participants and academics, proposes a set of six different tick increments.[9] Stocks would be categorized based upon their duration-weighted average quoted spread over a certain period of time. Importantly, a tick increment for a company would not be static as it could transition to a different increment after a data-driven review of how the security trades. In other words, objectivity, not subjectivity will drive the outcome. ASA supports the concepts included in the Nasdaq proposal and we believe it is time for Congress or the SEC to act upon such initiatives.

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[8] H.R. 2889 / S. 2306, 116th

[9] Intelligent Ticks: A Blueprint for a Better Tomorrow, available at https://www.nasdaq.com/docs/2019/12/16/Intelligent-Ticks.pdf

Scaling Regulatory Requirements for Small Issuers

As noted by the IPO Report, some of the more significant costs that fall on smaller issuers are related not to the IPO process but rather involve the cost of *being* public. The 1930's-era reporting regime is not fully equipped to handle the speed at which information flows today. Moreover, as disclosure and financial reporting requirements have steadily increased over the years, small issuers find that the cost of annual and quarterly reporting can be a major hindrance to going public. While the SEC has made some strides recently in reforming the corporate disclosure regime, there is much more that should be done to help small issuers and their investors navigate these often-burdensome regulations.

Potential reforms include:

- **Allow EGCs the option of issuing a press release with earnings every quarter instead a full 10-Q.** The IPO Task Force of 2011 – whose recommendations informed much of what ultimately became the JOBS Act – noted that 92% of public company CEOs reported the "administrative burden of public reporting" was a major challenge to becoming a public company.[10] Allowing EGCs the option to provide a basic press release – and still report their quarterly financials – would mitigate some of the costs associated with filing a 10-Q, while still providing investors with necessary material information. Legislation directing the SEC to examine the costs of quarterly reporting for EGCs was included as part of the JOBS and Investor Confidence Act.[11]

- **Allow all issuers the ability to use S-3 shelf registration forms and eliminate "baby shelf" restrictions.** Form S-3 is the most simplified and cost-effective form that issuers can file with the SEC. It allows them to pursue follow-on offerings by pulling already filed forms off the "shelf." Unfortunately, EGCs and small issuers remain prohibited from using such forms without the SEC providing any evidence that such restrictions put investors at risk. S-3 eligibility should be expanded to all issuers, and the "baby-shelf" restrictions that limit the amount an issuer can raise should also be eliminated. Legislation to implement these reforms has been introduced and considered in the House of Representatives for several years.[12]

[10] Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth – IPO Task Force (October 20th, 2011) Available at https://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf?mod=article_inline
[11] H.R. 4076, 116th *Modernizing Disclosures for Investors Act*
[12] Accelerating Access to Capital Act – H.R. 4529, 115th)

Direct Listings

The Securities Act requires all broker-dealers offering securities to the public to register with the SEC, to hold a specific amount of capital, and to submit to explicit liability under Sections 11 and 12 of the Securities Act as an underwriter of every security sold to retail investors through an IPO. In a traditional IPO, registered broker-dealers act as underwriters and work with the company and its counsel during the registration process to market the deal to institutional and retail investors. Underwriters also gauge investor demand, determine the clearing price, underwrite the offering, allocate shares, and utilize the over-allotment option to help protect and stabilize the offering. Subsequent to the public offering, underwriting brokers provide critical aftermarket support to the issuer which includes market making, equity research, investor relations advice, and non-deal investor outreach.

The securities laws have also allowed legal recourse for shareholders in cases where companies (or underwriters) make false or misleading statements or engage in other violations of the law. That is not the case with direct listings. In fact, one high-profile company that completed a direct listing (Slack) argued in court that it could not be held liable under Section 11 of the Securities Act for shares that are sold through a direct listing. Slack's contention is that when the company listed publicly, shareholders bought a "mix" of shares – some that were covered by the company's registration statement and others that were sold by insiders of Slack. They argue that because it would be hard to trace what shares were purchased by investors, they cannot be held liable under Section 11. This position is extraordinary and flies in the face of the very purpose of Section 11 liability.

Direct listings involve virtually none of the due diligence standards or legal remedies that benefit Main Street shareholders. In an age of overvalued "unicorns" – many of which consider IPOs or choose to go public – the role of underwriters is even more important. Imagine what would have happened if fallen unicorns such as Theranos decided to go public via direct listing before their risks became widely known.

Or take the more recent example of Coinbase, a cryptocurrency exchange that recently went public with a direct listing. Its share price plunged after Silicon Valley insiders unloaded shares on the public through a direct listing earlier this year. The stock continues to trade well below the high it made right after listing. Did retail investors benefit from this listing or did it only serve to enrich a handful of insiders?

Coinbase share price
Source: Google Finance

A rigorous underwriting process promotes accountability for all parties involved in a public listing and gives hardworking American retail investors the confidence and trust to participate in our capital markets. Unfortunately, in December 2020, the SEC disregarded these principles when it granted approval to an NYSE proposal to expand the use of direct listings for primary offerings – without the use of underwriters.[13] The SEC did so despite there being no economic or risk analysis supporting such an approval, and it never demonstrated why the longstanding IPO process somehow inhibits legitimate companies looking to go public.

We echo the concerns raised by SEC Commissioners Lee and Crenshaw regarding the NYSE proposal, who stated that investors will "face at least two significant and interrelated problems: first, the lack of a firm-commitment underwriter that is incentivized to impose greater discipline around the due diligence and disclosure process, and second, the potential inability of shareholders to recover losses for inaccurate disclosures due to so-called 'traceability'" problems."[14]

It's time for the SEC to acknowledge there are no shortcuts on the road to going public. We believe the decision on the NYSE proposal should be immediately reversed and that if the SEC ultimately decides some form of direct listings should exist in the market, it should require basic legal conditions to be met. In our view, these conditions include - at a minimum - the application of Securities Act liability for underwriters and the maintenance of legal remedies for shareholders who have been harmed by direct listings.

[13] https://www.sec.gov/rules/other/2020/34-90768.pdf
[14] https://www.sec.gov/news/public-statement/lee-crenshaw-listings-2020-12-23

Special Purpose Acquisition Companies (SPACs)

Along with direct listings, special purpose acquisition companies (SPACs) have become an increasingly popular means for private companies to access public markets. A SPAC is effectively a "blank check" company with no operations, and that lists on a national stock exchange with the intent of merging with another company within a certain timeframe (typically two years) which continues to be publicly traded.

SPACs can be speculative investments for investors. The surge in SPACs have come to be associated with celebrity endorsements along with regulatory questions about the potential risks they pose to investors. And while real questions about valuation previously existed, we believe the SEC's recent statement reclassifying warrants as liabilities under U.S. GAAP rules has provided investors and the markets with useful guidance about the fair value of warrant liability.[15]

SPACs can also be beneficial for investors. For example, there can be more time and information available to investors during the merger period, and investors in a SPAC typically have downside protection if a SPAC fails to acquire a target company within two years (via share redemption).

As with any policy changes, Congress and the SEC should carefully weigh the risks and opportunities of SPACs for investors, market function, and capital formation.

As the Committee examines the SPAC market, the ASA makes the following recommendations:

- SPAC sponsors should be required to provide disclosure regarding their economic stake and potential outcomes from a future merger transaction;

- Certain enhanced disclosures may benefit investors in SPAC transactions. For example, SPACs should clearly disclose to investors that a deal may not come to fruition and that shares may only be redeemed at a certain price. Investors should also be provided with merger information and a proxy statement (or a summary document of the merger document), including information for how the valuation was calculated;

- A Form S-4 and proxy statement should be filed at the same time (or shortly thereafter) a deal is announced; a SPAC should also have to publicly file a description of the transaction and how they determined valuation;

- SPAC sponsors should be subject to at least a one-year lockup in their shares from the date that the merger is completed; and

[15] https://www.sec.gov/news/public-statement/accounting-reporting-warrants-issued-spacs

- Any sales within a certain period (e.g. three years) by a SPAC sponsor should be considered a "distribution" under SEC rules.

Regulation SHO & Short Selling

The recent frenzy involving the trading of GameStop (GME) stock and other securities several questions regarding the current rules that apply to short selling. For example, at one point short sellers held a position that was 140% of the total outstanding shares of GME. How can this happen? Georgetown University Professor James Angel simply describes it like this: "the same shares can be lent over and over again."[16]

When this happens repeatedly, the level of short interest in a company becomes excessive and the stock becomes susceptible to a short squeeze. A short squeeze happens when traders decide to quickly exit their short positions by buying the shares of the company with the high short interest. This rush to buy forces the price of the stock to catapult higher.

A short squeeze can create volatility that impacts the fair, orderly, and efficient functioning of the market. In the case of GME, this is what happened. But the increase in price volatility was not confined to GME alone, it spread throughout the equity market to every mutual fund and ETF that held a position in GME.[17] This is how retirees, pensioners, working families, and mom-and-pop investors who didn't know they owned GME were impacted during the mania.

The next question to ask is whether there is any social good in allowing the short interest of a company's stock to exceed 100% of its shares outstanding, and if the answer is no, then we recommend that Congress and/or the SEC should thoroughly examine the details of the Reg SHO delivery rules[18] and the mechanics and pricing of stock lending arrangements.

A thorough examination should (1) determine whether "naked" short selling is still occurring in the market, (2) review the delivery exemption for market makers, which effectively allows them to fail indefinitely, (3) examine whether Reg SHO, which requires those who are short to buy back the stock at any price, contributed to and exacerbated market volatility, and (4) explore

[16] Angel, James J., Gamestonk: What Happened and What to Do about It (February 8, 2021). Available at SSRN: https://ssrn.com/abstract=3782195. Example Here: "Short sellers need to borrow shares in order to deliver them to buyers. Suppose that Shareholder #1 owns 100 shares. Shareholder #1 is more than happy to take some money from the short sellers by renting out the shares to Short Seller A. Short Seller A sells the borrowed shares to Shareholder #2. Likewise, Shareholder #2 is happy to take money from short sellers by renting the shares to Short Seller B. Short Seller B sells the shares to Shareholder #3. Shareholder #3 does not lend out the shares. Notice that in this example there are 300 shares of long positions (Shareholders 1,2, and 3) and 200 shares of short positions (Short sellers A and B), but only 100 actual shares".
[17] https://www.thestreet.com/etffocus/market-intelligence/etfs-gamestop-frenzy "XRT only rebalances on a quarterly basis, so there's no real mechanism for adjusting in between those dates (unless the fund wants to do a special rebalance, but those instances are rare). As a result, GME accounted for about 20% of the fund at its peak."
[18] https://www.sec.gov/investor/pubs/regsho.htm

whether the re-hypothecation of shares through stock lending arrangements (hard-to-locate or not) and the costs associated with such arrangements should be transparently disclosed to all market participants.

Conclusion

The ASA appreciates the opportunity to provide these thoughts and recommendations on the IPO market and we look forward to continuing to work with the SEC and Congress to provide a regulatory framework that both protects investors and promotes capital formation.

Sincerely,

Christopher A. Iacovella

Christopher A. Iacovella
Chief Executive Officer
American Securities Association