TESTIMONY OF JOSEPH L. SCHOCKEN

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Good morning, Chairman Chabot, Representative Veláquez, and members of the Committee. My name is Joseph Schocken, and I am the founder and President of Broadmark Capital LLC, a FINRA member broker-dealer based in Seattle, Washington. I appreciate the opportunity to appear before you today to discuss the critically important objective of reversing the decline in entrepreneurship.

Today's hearing could not be more timely or important. The United States is experiencing a serious decline in new company formation just as the economy struggles to absorb the impacts of automation and globalization. In fact, we now see companies disappearing at a faster rate than new companies are forming. I thank you for recognizing the significance of this trend and the need to take action.

Automation and globalization have created great benefits to consumers and investors, and at the same time fundamentally disrupted and changed the way our economy works. This paradigm shift is permanent, ongoing, and accelerating. A recent study by Forrester Research, Inc. projects that automation and robotics will displace nearly 25 million jobs — 17 percent of the American workforce — by 2027, and cause a net job loss of 9.8 million, or 10 percent of the workforce, over that same time period. While automation and globalization produce economic gains, more mature companies tend to shed US jobs in the process of adopting new technology and expanding internationally.

American workers are justifiably anxious about what this means for their futures, and their children's futures. How can people plan for retirement when they don't know whether their jobs will exist in three years? How can they save for their children's educations? How will the new generation joining the workforce be able to afford home ownership, or even health care?

The solution lies in the Innovation Economy, which has and will continue to keep our economy resilient in response to these changes. Innovation has been responsible for the vast majority of American economic growth, and job creation, since the Second World War. Young businesses have been the source of all net new jobs and nearly 20 percent of gross job creation over the past 30 years. Furthermore, employee compensation in innovation-intensive sectors increased by 50 percent between 1990 and 2007, a rate nearly two and a half times the national average.

We are here today, however, because the Innovation Economy is in trouble. The White House too has recognized this problem, and even before his inauguration President Trump announced the establishment of a Strategic and Policy Forum to advise the Administration on government policy to promote economic growth and job creation. That forum, however, is led by the CEOs of large corporate employers, whose challenges and economic impacts are uniquely different from those companies in the Innovation Economy.

Startups and small companies don't have the time or capacity to come to Washington to tell you what they need, and thus you don't have the feedback needed to make meaningful changes. The administration has recognized the value of a commission on economic issues; while this too is important, it currently reflects the interest of big business. I am therefore urging the formation of a Commission on the Innovation Economy to promote innovation and entrepreneurship. This

Commission would collect and synthesize information and make bipartisan recommendations for minor, near-term regulatory changes as well as address the long-term systemic issues facing the innovation economy.

This commission would address the two greatest challenges facing would-be entrepreneurs and startup companies: accessing capital and managing regulatory requirements.

Access to capital has never been easy, but it has become especially difficult in recent years. New businesses must spend a great deal of time and energy on finding capital, rather than on executing their business plans, and too often this capital is simply unavailable. Both the number of venture capital firms and the number of public companies have declined by half over the past twenty years, and we see capital increasingly concentrated, both geographically and by company. Nearly fifty percent of venture money now goes to firms in the Bay Area, and in the second quarter of 2016, almost 40 percent of all venture money went to so-called "unicorn" firms, startup companies that already have a market value of more than a billion dollars.

New companies must also wrestle with complex regulatory environments that are often designed for much larger, more mature companies. Even understanding compliance requirements often requires hiring personnel or outside expertise that startups cannot afford.

I was honored to be part of the legislative process that produced the JOBS Act of 2012, which sought to address these concerns. The JOBS Act passed with broad bipartisan support, and has already revealed how small regulatory changes can make a difference. The regulatory relief provisions of the JOBS Act have led to new capital and job creation, with no negative impacts.

Work, however, remains to be done. Our experience with the JOBS Act and the five years of market response since its passage suggest a path for further reform. This Congress has a real opportunity to apply the market feedback to refine the innovation economy's regulatory environment, and make an even greater impact for small businesses and entrepreneurs.

In the near term, several minor policy tweaks would have real and immediate positive effects on our Innovation Economy.

First, fix general solicitation. The ability to raise capital from accredited investors is an enormously important part of capital formation for early-stage companies. General solicitation under JOBS Act reform was expected to boost capital formation by expanding Regulation D; from September 2013 through 2015, $70 billion of the $2.9 trillion raised under Regulation D used general solicitation. While only a small part of the total Regulation D funding, this produced capital which created new companies and jobs. This number, however, would be much higher without the burdensome investor verification requirement. The JOBS Act's changes to general solicitation have already had a positive impact, but minor regulatory changes could unleash this strategy's full potential.

The SEC's regulations on third-party verification have had a chilling effect on capital formation. These regulations fixed a problem that did not exist. Congress should eliminate the requirement for investor verification and allow investors to self-certify under penalty of perjury, which would be a higher standard than applies to other private security offerings. This change alone would encourage capital formation and create millions of jobs.

Even an SEC whitepaper from October 2015 raised early concern that the investor verification requirement may be stifling the success of general solicitation. Industry participants corroborated these findings at the SEC's 2016 Forum on Small Business Capital.

When Congress considered the general solicitation provisions of the JOBS Act, many academics, journalists, and thought leaders at the SEC expressed concern about the possibility of investor fraud. In the spring of 2012, we saw articles in the business press with headlines that warned, "JOBS Act Will Open Door to Investment Scams." It is important and gratifying to note that these concerns about investor abuse never materialized. In fact, the SEC's Division of Economic Risk and Analysis last year observed "no measured increase in the incidence of fraud in the new Rule 506(c) market."

Second, **fix equity crowdfunding**. Crowdfunding, perhaps the JOBS Act's boldest provision, has failed to meet expectations. A meager $38 million has been raised for 142 companies since May 2016. By comparison, $1.3 trillion was raised under Regulation D for more than 30,000 companies in the most recent calendar year reported by the SEC (2014).

Despite the nominal dollar value, the SEC's research has shown that crowdfunding is providing a new source of capital for small businesses that may not have otherwise had access to capital. Crowdfunding brings capital to areas underserved by capital markets. Nearly forty percent of crowdfunding campaigns were in areas classified as inner city by the Initiative for Inner City Competitiveness, a non-profit dedicated to enhancing inner city property through private investment.

The success of Kickstarter has demonstrated the need for this type of capital, and Indiegogo, a rewards-based investor website, has partnered with MicroVentures to provide both rewards-based and equity crowdfunding. Government policies should make it easier for entrepreneurs to attract traditional investment through funding campaigns.

The rules for crowdfunding, however, remain overly burdensome for small entrepreneurs seeking modest amounts of capital. The audit requirements for crowdfunding are cumbersome for small businesses, as evidenced by the transactions to date, which have clustered just at the threshold for required audits. Raising this capital threshold will encourage more businesses to take advantage of crowdfunding. The rules should also provide for relief from penalties for startups acting in good faith.

Third, **make it easier for small companies to make initial public offerings (IPOs)**. Despite the intentions of the JOBS Act, high costs and regulatory burden keep the traditional IPO unattractive to small companies. These companies may have access to private sources of equity, but the IPO is what creates jobs. Investors in privately held companies prioritize return on investment, while investors in public companies expect growth. Growth creates jobs. Growth requires innovation.

Next, **expand the pool of accredited investors**. Keep the current standards in place, but expand the qualification criteria to allow people to meet those standards through employment and/or education. Knowledgeable employees of early-stage companies in high-growth industries may not have enough money to qualify under current rules; they should be allowed to invest in the companies they're helping to create, based on their education and job experience.

The SEC is considering a proposal to tighten accreditation standards, which would be exactly the wrong decision. Tightening these standards could eliminate nearly 60% of accredited investors, who provide more than one trillion dollars of capital yearly, in private placements. Such a change would devastate capital formation in the innovation economy. We encourage you to support Congressional efforts that maintain current standards, and allow these standards to rise with cost of living adjustments.

Finally, **allow early stage companies to sell net operating losses to raise capital.** If companies are permitted to treat net operating losses as an asset, they can leverage the risk capital invested in the company into additional cash — without further investor risk. Profitable companies would be able to provide significant new funding to early stage companies that are not yet earning a profit.

The changes discussed above can be made before the establishment of a Commission, although the Commission's expertise and guidance would be valuable. That expertise and guidance, however, will be essential as policymakers examine and address the major long-term issues that impact the Innovation Economy. These include:

- **The disappearance of small IPOs.** Today's IPOs start at $100 million, and the smaller IPOs have disappeared. This is a major reordering of the American economy, and requires policy changes beyond the small fixes suggested above. The disappearance of small IPOs is keeping job growth artificially low, and has exacerbated the regional imbalance in entrepreneurship. Regional and mid-sized businesses — small manufacturers, retailers, and craft brewers, for example — used to be able to make an initial public offering of $25 million to fuel growth that created hundreds, even thousands of jobs. When this source of capital disappeared, the jobs disappeared as well. Reviving regional IPOs could make a huge difference in parts of the country the economic recovery has left behind. Regulation A+, mandated by the JOBS Act, was intended to facilitate small businesses' path to IPOs, but is still not the most compelling option for financing. Structural issues have magnified the headwinds facing small companies that seek public capital. These include compliance burdens that favor larger companies and the move to passive investing and indexing, which mean lower trading volumes and valuations for equities outside of indexes, and fewer retail brokers to sell an IPO.
- **The decline in the number of public companies.** The precipitous drop in the number of public companies is harmful to the economy in many ways. Public companies enhance the transparency of capital markets and broaden the investment choices for investors' portfolios, and their lower cost of capital implies more efficient markets. As I have noted, and will repeat, IPOs

are also true job-creating events. Investors in public companies expect long-term, continuing growth, and this growth creates jobs. SEC Chairman Clayton has said that the agency is encouraging more companies to go public, noting last month that the current trend "ultimately results in fewer opportunities for Main Street Americans to share in our economy's growth, at a time when we are asking them to do more on their own to save and invest for their future and their children's futures."

- **Geographic concentration of venture capital**. Fifty percent of all venture capital currently flows to one state, California. This is a tremendous imbalance that resonates throughout the country, and is already causing systemic distortions in the job market. The disparity in access to capital is a major contributor to the divergence of wealth among regions throughout the United States. Inventive ideas and people are not confined to the coasts.
- **Concentration of control of venture capital.** Venture capital has not only become concentrated by region, but it now comes from fewer sources and is allocated to fewer companies. The number of venture capital firms has declined by 50%, while the amount of venture capital in the market remains steady. Fewer people and companies are controlling the same amount of money, and it's most efficient for them to allocate those funds to fewer projects in larger dollar amounts. The five to ten million-dollar first round of professional investment has largely disappeared. A Commission would examine the reasons for this concentration, consider various reform possibilities, and make meaningful policy recommendations.

The American economy has historically led the world in innovation and entrepreneurship. Today, however, the United States faces new levels of international competition as both allies and adversaries recognize the importance of encouraging innovation. As we seek to maintain our position in setting the global standards for fostering entrepreneurship, the United States can benefit from studying other nations' initiatives — such as France's Station F, a new $265 million startup campus in Paris that brings as many as 1,000 founders of new companies together from around the world to share ideas and pool resources.

If the United States is to remain the world leader in innovation, we must restore the American innovation machine. A bill to create a Commission on the Innovation Economy that would make recommendations for both short-term fixes and long-term policy goals is about to be introduced in both houses. I want to thank the members on both sides of the aisle who are leading this effort. You know that enacting legislation is a time-consuming and laborious process. Action from the White House in this area would also be welcome; the administration could establish a commission similar to the Strategy and Policy Forum, but for smaller, younger businesses.

A prospering Innovation Economy is the key to creating jobs, increasing wages, and reducing income inequality as companies compete for good employees. Again, I thank you for taking the time to address this crucial issue, and I look forward to working with you on solutions that will revive and encourage entrepreneurship. I would be happy to answer any questions you may have.