SVB Financial Group

TESTIMONY OF MICHAEL T. LEMPRES
ASSISTANT GENERAL COUNSEL & PRACTICE HEAD
SVB FINANICAL GROUP, INC.

BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING ON:
A PROPOSAL TO INCREASE THE OFFERING LIMIT UNDER SEC REGULATION A

DECEMBER 08, 2010

Chairman Frank, Ranking Member Bachus and Members of the Committee:

Thank you for the opportunity to speak with you today on the topic of providing access to capital for start-up and emerging growth companies, an issue that affects every American and every part of our economy. My name is Mike Lempres, and I represent SVB Financial Group and its subsidiary, Silicon Valley Bank. Thank you for allowing me to submit my full statement for the record.

In your invitation to testify, you asked witnesses to address six specific questions about SEC Regulation A and its possible revision. For your convenience, I reproduce the questions and provide responses at the end of this statement. In the rest of my statement, I provide the Committee with my views about the potential revision of Regulation A and the broader issue of improving access to capital for high-growth small businesses.

SVB Financial Group

As you may know, SVB Financial Group has a deep connection with emerging growth companies across the United States, and our platform gives us insight into both debt and equity funding channels. We are the premier provider of financial services for companies in the technology, life science, venture capital and premium wine industries.

SVB is a bank holding company and a financial holding company. Our principal subsidiary, Silicon Valley Bank, is a California-chartered bank and a member of the Federal Reserve System. As of September 30, 2010, SVB had total assets of $14.75 billion. Through Silicon Valley Bank and our other subsidiaries, we provide a comprehensive array of banking services including lending, treasury management, trade finance, and foreign exchange services to our clients worldwide.

We began serving the technology and life science markets in 1983. Over nearly three decades, we have become the most respected bank serving the technology industry and have developed a comprehensive array of banking products and services specifically tailored to meet our clients' needs at every stage of their growth. As a result, today we serve more than 13,000 clients through 26 U.S. offices and international offices located in China, India, Israel and the United Kingdom and provide banking services for approximately half of the venture-backed technology companies across the country.

In addition to our core banking business, SVB (the holding company) also has sponsored venture capital funds, through our SVB Capital division, and made investments in certain third-party venture funds. We conduct our funds business in accordance with applicable law and use shareholder (not depositor) money for our fund investments.

The Importance of High-Growth Small Businesses and Their Access to Capital

The health and growth of small companies is critical to the competitiveness of the American economy and to the quality of our lives. President Obama recently described the importance of small businesses to the American economy, as follows:

> Over the past fifteen years, small businesses have created roughly 65 percent of all new jobs in America. These are companies formed around kitchen tables in family meetings, formed when an entrepreneur takes a chance on a dream, formed when a worker decides its time she became her own boss. These are also companies that drive innovation, producing thirteen times more patents per employee than large companies. And, it's worth remembering, every once in a while a small business becomes a big business – and changes the world.[1]

The President is absolutely right that America needs healthy, growing small businesses. SVB's particular focus is on high-growth small businesses. As recent studies have

[1] Address by President Barack Obama before the Brookings Institution (Dec. 8, 2010).

demonstrated, these businesses (rather than small businesses more broadly) are the principal force behind both gross and net new job creation.[2]

One statistic in particular highlights the powerful effect investments in high growth companies have on our economy. Investments by venture capital funds in these businesses represent only roughly 0.2% of U.S. GDP. Yet, as of 2008, venture-backed companies employed more than 12 million people (approximately 11 percent of total private sector employment) and generated the equivalent of 21 percent of U.S. GDP. In other words, capital that flows into small high-growth businesses is capable of returning to the broader U.S. economy approximately 100 times the amount originally invested, in the form of new jobs and higher revenues.

In order to grow, small companies need to have access to appropriate funding at each stage of their development. As a country, we have demonstrated our ability to innovate. We can generate the ideas that will continue to transform how we care for illnesses, how we communicate, how we generate and use energy, and the myriad other areas in which technology shapes our economy and our lives. Yet to maintain our global leadership in the innovation and technology sector, and to allow companies to grow from ideas into large, robust enterprises, our economy must also provide them with an efficient way to access suitable capital at each stage of their growth.

Access to Capital is a Challenge for Emerging Growth Companies

Access to capital is a major concern for small issuers. In the spring of 2010, we surveyed more than 300 emerging and early-stage companies with annual revenue of less than $5 million. These companies said that access to capital was their number one concern. That concern is well-founded, as the systems that fund high growth businesses are under stress.

Companies turn to a variety of sources of capital, beyond Regulation A. (In fact, as discussed below, Regulation A typically is not used and does not contribute in a meaningful way to capital formation for small companies.)

One source of capital is debt. Silicon Valley Bank exists largely to make loans to high growth technology companies, and we do so robustly. For example, in 2009 we made 407 new loans to business clients, for a total of $977 million in new loan activity, and in the most recent quarter of this year we extended 423 new loans to business clients. Overall, SVB's loan portfolio has grown from $2,843,353,000 at year-end 2005 to $4,859,205,000 at September 30, 2010. While our experience is not representative of the broader financial services sector given our focus on technology clients, our history does illustrate that debt has continued to be available

[2] J. Haltiwanger, R. Jarmin and J. Miranda, *Who Creates Jobs? Small vs. Large vs. Young,* NBER Working Paper No. 16300 (Aug. 2010).

to growth companies throughout the financial downturn and has grown substantially over the past five years.

Even where credit is available to growing companies, it is not the right solution for the funding needs of all companies. Indeed, credit is only one of the options available to companies that seek capital. Equity based financing options are critical to growing companies. Companies can obtain capital through a number of equity channels, including private investors (often referred to as angel and super angel investors), venture capital funds, initial public offerings *("IPOs")* and Regulation D issuances.

Venture capital financing has been an essential component of the innovation sector for decades. While venture funds invest in a relatively small number of companies (experts estimate that approximately 1% of companies that seek venture funding actually receive it[3]), these companies outperform the broader economy in both job creation and revenue growth.[4] As a result, while venture capital is critical to our economy, individual emerging companies cannot rely on obtaining its benefits and it alone cannot be seen as the sole source of capital for startup companies.

Public capital markets traditionally have been a core source of growth capital for U.S. companies. In recent years, however, accessing these markets through IPOs has been very challenging. For example, in 1999 there were 269 IPOs of venture-backed companies. In 2009, there were twelve. This reflects, among other things, the dramatically higher costs of taking a company public today as well as structural changes in the underwriting and capital markets businesses.[5] We encourage the Committee to consider ways to strengthen the IPO process at another time.

Regulation D provides another set of paths to access capital, which do not carry the same regulatory requirements as public offerings. Rule 504 provides an exemption from SEC regulations for offerings up to $1 million, and Rule 505 provides an exemption for offerings up to $5 million. Rule 506 provides no cap on the offering amount. All Regulation D offerings prohibit any general advertising of the offering, and all impose resale restrictions on the securities. In exchange for the higher offering limits, both Rule 505 and Rule 506 limit the

[3] 2010 National Venture Capital Association Yearbook, at page 7.

[4] HIS Global Insight, *Venture Impact: The Economic Importance of Venture-Capital Backed Companies to the U.S. Economy (5th Ed.)* (2009).

[5] The IPO process has become an expensive one for many reasons, including underwriting, legal and other fees associated with the offering itself as well as compliance costs for public companies. The end result is that the traditional IPO is generally only appropriate for companies with a market value of approximately $250 million or more.

investor pool. Rule 506 requires that all investors be either accredited or sophisticated. Despite these restrictions, Regulation D is used, particularly Rule 506. Regulation D offerings provide a useful option to both companies and investors. Like other options, Regulation D is not appropriate for most companies, and it is not a substitute for the proposed revision to Regulation A.

Regulation A Aims at the Right Target, but Misses and Should be Revised.

The impetus behind the creation of Regulation A was a good one. Congress properly recognized a stage in the growth cycle of companies that was not being met. Emerging growth companies seeking a moderate amount of capital face different challenges than either very small startups or larger companies.

Unfortunately, Regulation A has not proved to be a useful capital raising vehicle for small issuers. It was used only a total of 78 times during the ten years between 1995 and 2004. An average of eight filings a year, with a maximum amount of $5 million each, proves the irrelevance of Regulation A as it stands today. It simply is not a viable vehicle for raising funds and is providing benefit to neither companies nor investors.

The SEC used its discretion to reach the Regulation A offering size ceiling of $5 million in 1992, and it has stayed there since. The $5 million ceiling was never high enough to warrant the costs and burdens of going public through a Regulation A offering, and the effect of inflation since 1992 has exacerbated that core problem. Quite simply, the transaction costs and costs attended to being publicly traded are too high to justify Regulation A offerings with a $5 million ceiling.

The proposed revision of Regulation A strikes a better balance. If Regulation A is to become effective, the offering size limit must be raised. In addition, the proposal would give regulatory discretion to the SEC in implementing the revised Regulation A. Such discretion is needed so that rules can be amended to strike the proper balance between protecting investor confidence and providing an effective means to access capital for growing companies. It is important that the SEC consider the cumulative impact of individual mandates so that the revised Regulation A can become an effective capital raising vehicle for small issuers.

Other Issues that Affect the Ability of Small Issuers to Raise Capital

A major issue for Regulation A offerings and other SEC-exempt offerings is the applicability of state blue sky laws. A small company that is exempt from SEC registration pursuant to Regulation A must still either register its securities with each state in which it offers the securities or qualify for a state exemption from registration. This is a cumbersome and expensive effort. Raising the Regulation A offering limit will make the process more attractive to issuers, but the applicability of state blue sky laws will continue to discourage use of even a revised Regulation A.

Congress may chose to exempt state registration laws that otherwise apply to securities issued under SEC exemptions. In the past, Congress has considered amending the National Securities Markets Improvement Act of 1996 ("NSMIA") to preempt state blue sky laws for securities exempted from registration by the SEC. Such a state preemption is not in the discussion draft proposal we have been asked to discuss. A broad-based exemption from state registration requirements would greatly reduce the transaction costs associated with raising capital through an SEC registration exempt issuance.

<u>Responses to the Committee's Questions</u>

(1) Under the current offering limit of $5 million, is Regulation A a useful capital raising vehicle for small issuers? Will increasing the offering limit to $30 million materially enhance its utility as a funding source? Is $30 million an appropriate limit for Regulation A offerings? Please address factors such as inflation and the costs of developing products and technologies.

As I have indicated in my general comments, Regulation A, as currently structured, is not a useful capital-raising vehicle for small issuers. The proof is in the pudding: Regulation A is simply not used.

I believe that increasing the offering limit to $30 million would materially enhance Regulation A's utility as a funding source. Moreover, I believe that Congress and the SEC could further increase the utility of Regulation A by reviewing the federal and state compliance and other costs associated with a Regulation A issuance.

In terms of the size of the Regulation A limit, while a $30 million is helpful, a $50 million limit would make Regulation A offerings more useful. The additional capital would make a real difference in some sectors of the broader innovation economy that are more capital intensive. Clean energy companies, for example, will tend to require substantial capital to establish that a new technology is commercially feasible. Similarly, life science companies may face substantial costs even beginning the regulatory approval process required to develop a new product. Permitting issuances up to $50 million will help companies establish themselves in these capital intensive sectors, and issuances of that size present a fundamentally similar risk for investors.

(2) Please comment on the availability of alternative funding sources for small issuers, such as offerings under SEC Regulation D and credit facilities. Please provide any views you have on how an increase in the Regulation A offering limit could complement these other funding sources.

Access to capital is a major concern for small issuers. As discussed above, SVB's *Startup Outlook 2010* survey, conducted in February of 2010, indicated that access to capital was the number one concern for early stage technology companies.

As discussed above, small issuers do have alternative funding sources, but the needs of companies of different types and at different stages of their growth require a wide variety of alternatives. Credit facilities play a significant role, and in some sectors (such as the ones we serve) credit is flowing. Regulation D, angel investors, venture capital, intrastate offerings and private offerings all present additional options for small issuers. Each presents different benefits and limitations. As discussed above, however, many of these funding channels are currently facing stresses, and access to capital presents a challenge to emerging growth companies.

Increasing the Regulation A offering ceiling will open doors for some companies by making access to capital more efficient, and therefore, more attractive. A more robust Regulation A funding channel should not cannibalize other funding sources. Instead, it should help the economic pie grow by providing additional capital to some who would otherwise not obtain it or not obtain it as efficiently.

(3) Should Congress simply authorize the SEC to increase the offering limit under Regulation A, or should Congress affirmatively require the SEC to do so? Should Congress give the SEC discretion to establish the terms and conditions under which the increase is implemented, or should Congress stipulate those terms and conditions? What would be the impact if Congress or the SEC were to require the submission of audited financial statements in connection with Regulation A offerings?

It is important for the offering limit to be raised, and it is appropriate for Congress to legislate the increase. Once that clear policy directive is established, the SEC is the appropriate entity to establish terms and conditions for implementation. The balancing required for effective implementation will be best achieved through a rulemaking process and the expertise of the SEC. Moreover, specific rules can be modified more easily to adapt to changes or unanticipated consequences if they are established by regulation than if they require legislation.

The decision about whether to require audited financials should be made as part of a broader decision that considers the totality of the requirements imposed by a revised Regulation A. In isolation, requiring audited financial statements may be a rational, reasonable requirement. However, a regulatory process that layers a series of rational, reasonable requirements on Regulation A issuers can quickly vitiate Regulation A's effectiveness. For that reason, the SEC should be tasked with determining what terms and conditions, including audited financials, best balance the objective of providing efficient access to capital for small businesses with the objective of protecting investors.

(4) What are the benefits of raising the offering limit under Regulation A? Please address factors such as the potential impact on job growth and the development of products and technologies by emerging companies. Please quantify your responses if possible.

If the offering limit under Regulation A is raised and companies find it a practical and efficient way to raise funds, the benefits are potentially enormous. Growing companies are the engine of job growth for our economy. If Regulation A is accessed viable vehicle, companies will have a means to obtain capital that they otherwise would not have been able to access. That capital will permit investments in growing companies and lead directly to job growth.

Moreover, as the President recognized, a disproportionate amount of new products and new technologies are developed and commercialized by emerging companies. These companies are often more nimble, more entrepreneurial and less invested in the status quo than larger companies. Thus, it is the emerging company that often implements improvements and disruptive technologies that help revolutionize the way we work and live.

Finally, some sectors within the broader innovation economy are capital intensive and, today, struggling with "valleys of death." In the clean energy sector, for example, it is very difficult for companies to obtain adequate, appropriate funding to finance their first commercial-scale facility. These companies have demonstrated the viability of their technologies through a prototype, but unless they are able to take the next step – building a commercial-scale facility – the benefits of their innovation will not be realized.

(5) Are there any drawbacks to raising the offering limit under Regulation A? Will raising the limit increase risks to investors? What safeguards might be necessary to mitigate those risks? Would requiring audited financial statements in connection with Regulation A offerings be sufficient to address any increased risk to investors?

Congress' goal should not be on eliminating risk from our economy – rather, it should be to ensure that risks are well understood, accurately communicated and effectively managed. This issue is illustrated by the current state of Regulation A. It is not used; therefore, it presents virtually no risk. In a technical sense, raising the Regulation A offering limit will by definition increase risks to investors; it will also create a benefit that doesn't exist today.

An appropriately designed Regulation A offering process will allow investors who like the risk-reward potential of a growth company to make investments in these companies. The investment risk in smaller companies cannot be mitigated fully, but it can be disclosed and priced appropriately.

Any drawbacks to raising the offering limit under Regulation A are far outweighed by the benefits of raising the limit. The basic trade-off for all registration exemptions is the efficiency of raising funds versus the perception of investor confidence. Funds can be raised and used to invest in capital, hire employees, and growth businesses more efficiently when there are fewer transaction costs to obtain the funds. The goal is to optimize the trade-off, so that companies can access necessary funds and investors can make informed and accurate choices about investing.

As discussed above, providing audited financial statements may increase investor confidence and provide some incremental risk-reduction to investors. Unfortunately, it will also increase the costs and burdens of raising funds through Regulation A. The SEC is in the best position to balance these objectives as part of a comprehensive review of how a revised Regulation A should be implemented.

(6) What would be the impact of establishing an exchange trading platform for Regulation A offerings? Would exchange trading enhance the value of Regulation A as a capital raising device? What benefits or risks would it pose to investors? How would exchange trading affect the applicability of state law to Regulation A offerings?

A Regulation A exchange could be beneficial for both companies and investors. Even if amended, Regulation A funding would likely not qualify companies for trading on the existing major exchanges. Exchanges typically require a minimum market capitalization of $50 million. An exchange geared toward smaller companies could increase the protections available to investors and deepen the liquidity available to smaller company stocks.

We can learn from the experience of the London Stock Exchange in creating a small issuer exchange. The Alternative Investment Market ("AIM") provides some lessons about the trade-offs of reduced regulatory compliance costs for companies and the provision of accurate, sufficient information for investors. AIM has faced substantial challenges in providing adequate liquidity and developing investor confidence, and a U.S. based exchange would require some regulatory flexibility to meet those challenges.

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I applaud this Committee for recognizing the essential place that availability of capital for emerging growth companies occupies in our economy. Thank you for this opportunity to present information on such an important topic. I will be pleased to answer any questions.