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NAVIGATING REGULATIONS: ALTERNATIVE PATHWAYS TO INVESTING IN SMALL BUSINESSES

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT, INVESTIGATIONS, AND REGULATIONS

OF THE

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CONTENTS

OPENING STATEMENTS

	Page
Hon. Beth Van Duyne	1

WITNESSES

Mr. Parag Shah, Co-Founder & Chief Technical Officer, Vemos, Washington, DC	3
Ms. Mary Kennedy Thomposon, Chief Operating Officer, Neighborly, Waco, Texas	5
Mr. Jeremy Kress, Assistant Professor of Business Law, University of Michigan, Stephen M. Ross School of Business, Ann Arbor, MI	7

APPENDIX

Prepared Statements:	
Mr. Parag Shah, Co-Founder & Chief Technical Officer, Vemos, Washington, DC	19
Ms. Mary Kennedy Thompson, Chief Operating Officer, Neighborly, Waco, Texas	25
Mr. Jeremy Kress, Assistant Professor of Business Law, University of Michigan, Stephen M. Ross School of Business, Ann Arbor, MI	33
Questions and Answers for the Record:	
Questions from Hon. Velázquez to Mr. Jeremy Kress and Answers from Mr. Jeremy Kress	42
Additional Material for the Record:	
Engine Letter	45

NAVIGATING REGULATIONS: ALTERNATIVE PATHWAYS TO INVESTING IN SMALL BUSINESSES

TUESDAY, MARCH 12, 2024

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON OVERSIGHT,
INVESTIGATIONS, AND REGULATIONS,
Washington, DC.

The Subcommittee met, pursuant to call, at 10:04 a.m., in Room 2360, Rayburn House Office Building, Hon. Beth Van Duyne [chairwoman of the Subcommittee] presiding.

Present: Representatives Van Duyne, Alford, Crane, Bean, and Gluesenkamp Perez.

Chairwoman VAN DUYNE. I will now call the Subcommittee on Oversight, Investigations, and Regulations to order. Without objection, the Chair is authorized to declare a recess of the Committee at any time.

I now recognize myself for my opening statement.

I want to welcome all of you here today. This hearing will highlight how small businesses across the nation are struggling to access capital because this administration continues to impose undue restrictions. Access to private credit is more critical today than it has ever been, and I want to thank our witnesses for joining us to have a robust conversation on this topic. I am eager to hear from you and to discuss how we can empower our job creators to access the investment sources they need to grow.

Small businesses across America are continuing to navigate economic challenges in a post-pandemic world, alongside the repercussions of reckless government spending that has given us decades high inflation and crushing interest rates. Coupled with stifling regulations implemented by this administration, it is now more expensive and strenuous to do business than ever before. Our job creators rely on access to capital to keep their doors open, and without stable access to capital, our small businesses don't have the certainty that they need to grow, or in some cases, just to survive. Along with limited access to small business investment options, bank lending standards have grown stricter and loan growth has slowed significantly, making it much harder for mom and pops shops to stay afloat.

Instead of lenders being able to make decisions based on business models and risk assessment, this administration is forcing them to base investment decisions on demographic quotas. Entre-

preneurs, job creators, and employees at small businesses are much more than demographic boxes to check. Small businesses are critical to communities across our country and are the result of innovation and hard work. And as I have heard from a constituent who is a community banker, capital is sitting there unused and her hands are tied. Our small businesses are getting left behind because this administration continues to impose new regulations and direct investment where they think is best, rather than allowing meritocracy to prevail.

Over the next decade, compliance with President Biden's regulations will cost Americans more than $1.5 trillion. Since the day President Biden took office, he has burdened our job creators with more than 287 million hours in additional paperwork. As regulatory complexity grows, so do costs to do small business that are already burdened by this administration. As we've heard time and time again, over regulation can shutter the doors of any small business. These regulations make it difficult or even impossible for businesses to comply, to compete and survive, let alone make a profit.

Private credit, which comes from nontraditional investors, has long been a lifeline for entrepreneurs across the country. But it is especially important now given this administration's agenda. As the federal government attempts to regulate our small businesses out of existence, private investment is stepping up to fill the void. More than 80 percent of investments made by private equity support small businesses. In my district, more than 130,000 jobs are supported by private equity. The bottom line is private financing has grown because it is needed, useful, and is successful at helping American businesses in every sector, from healthcare and biosciences to energy production and consumer services.

I am grateful to our small businesses and I am grateful that they have this option. I am also glad to be able to hold this hearing today to put the needs of our job creators first and push back on the Biden Administration's destructive regulatory environment.

We are going to go ahead and move forward to introducing our witnesses that are here today. I want to thank each and every one of you. Our first witness is Mr. Parag Shah. Mr. Shah is the Co-Founder and CTO for Vemos, which is located in Minneapolis, Minnesota. Vemos is a mobile payments and analytics company that serves the hospitality industry by creating personalized digital experiences. Prior to founding Vemos, Mr. Shah founded Fidelity LLC, bringing technology ideas to the market, working with him and working with creating other technology companies. While still in college, he found MX app building a product called Lunchbox, allowing customers to order from restaurants using their phones. He was named a finalist in the 2009 Global Student Entrepreneur Awards. Mr. Shah graduated from the University of Minnesota's Carlson School of Management, where he earned his degree in entrepreneurial management. Thank you for joining us today and we look forward to the conversation ahead.

Our next witness here today is Ms. Mary Kennedy Thompson. Ms. Thompson is the Chief Operating Officer for Neighborly, a holding company of 29 brands focused on home services located in Waco, Texas. At Neighborly, Ms. Thompson oversees all business

operations within the company and works with 17 brand presidents, leading the execution of strategies and initiatives. Prior to being appointed COO, she served as Executive Vice President of Neighborly and President of Mr. Rooter. Prior to her experience franchising, Ms. Thompson served 8 years in the U.S. Marine Corps as a logistics officer. She is the recipient of the International Franchise Association's Bonnie Levine Award. The highest award for women who have made an impact on franchising. Ms. Thompson graduated from the University of Texas at Austin with a Bachelor of Arts in English. She then went on to complete the Mini MBA Program in franchise management from the University of St. Thomas College of Business. Thank you for your service and thank you for being with us today.

Our final witness is Professor Jeremy Kress. Professor Kress is an Assistant Professor of Business Law, at the University of Michigan's Stephen M. Ross School of Business. Before entering academia, Professor Kress was an attorney in the banking regulation and policy group at the Federal Reserve Board of Governors here in Washington. He served as counsel to the Assistant Attorney General for Antitrust at the U.S. Department of Justice, focusing on bank merger policy. Professor Kress is an expert on banking policy and capital formation issues and has previously testified before Congress on these matters. Professor Kress graduated cum laude from Harvard Law School and from the Harvard Kennedy School, where he was a presidential scholar. He holds a BBA from Michigan Ross. Professor Kress, thank you again for being here today.

Before recognizing the witnesses, I would like to remind them that their oral testimony is restricted to 5 minutes in length, and if you see the lights turn red in front of you, it means your 5 minutes have concluded, and you might hear a little bit of a gavel. But you should wrap up your testimony. So I now recognize Mr. Shah for his 5 minutes opening remarks.

STATEMENTS OF MR. PARAG SHAH, CO-FOUNDER & CHIEF TECHNICAL OFFICER, VEMOS; MS. MARY KENNEDY THOMPSON, CHIEF OPERATING OFFICER, NEIGHBORLY, AND MR. JEREMY KRESS, ASSISTANT PROFESSOR OF BUSINESS LAW, UNIVERSITY OF MICHIGAN, STEPHEN M. ROSS SCHOOL OF BUSINESS

STATEMENT OF PARAG SHAH, CO-FOUNDER & CTO, VEMOS

Mr. SHAH. Thank you. Chairwoman Van Duyne, and Members of the Subcommittee, thank you for inviting me to testify today regarding the experience of alternative financing for small businesses. My name is Parag Shah and I am the Co-Founder of Vemos, a Minnesota based company that creates personalized experiences between hospitality businesses and their guests. Using our app, consumers can view a personalized menu tailored to their allergies and dietary needs, quickly view and pay their bill, and get rewarded from their favorite spots. Simply put, our software helps restaurants better understand their customers and provide more personalized guest experiences, which in turn allows them to grow their business.

I have spent my entire career dedicated to starting and scaling businesses. Prior to Vemos, I have been the founder of several technology companies, many of which have failed, but a few have succeeded. I am also a mentor for rising tech entrepreneurs and I am a proud member of ACT, the App Association, a trade group for representing small tech companies like mine.

When most people hear the words entrepreneur or tech startup, they think of successful unicorns featured in the media. But the reality is, building a company is extremely difficult and the outcomes are not guaranteed, no matter the background, the effort of the team, or funding received. And for those of us that are crazy enough to choose this, it is vital for there to be an opportunity to succeed, not just for the founders, but for every single person involved in the journey.

While there are many types of small businesses, my entrepreneurial story has centered around technology and software, where some level of funding is typically necessary to grow. The funding can come in many forms and isn't limited to venture capital. Although we have raised venture capital, I have more experience with widely used investment rounds such as friends and family, angel, and seed. The reality is most entrepreneurs don't have connections to investors and capital, while businesses like ours struggle with traditional options like bank loans, even ones backed by the SBA, because we don't have traditional assets. Therefore, outside private capital is very important to us.

One of the best parts about being in software is how quickly you can build and test an idea with limited upfront capital. It is scaling the business that comes with the funding hurdles. In 2007, when I started my first company while attending the University of Minnesota, this is exactly what happened. A few of us came up with an idea, started writing code, and tested our product with real customers. It turned out that we had a winning product on our hands. That is when the real work started, and that is when the funding was necessary. At the time, there weren't as many resources for founders as there are today. Plus, much of the capital was concentrated on coasts. Even after gaining traction, we struggled to raise capital locally, and as first-time founders and students, we had no capital ourselves and a resume that did not help investors. We were fortunate to close a small round of angel investors to grow our business, but at the time we were not educated to find additional capital elsewhere. After a lot of struggle and sweat equity, we were able to exit, but far less than what I believe we should have achieved if we were given the right resources.

Today, early stage tech entrepreneurs are fortunate to have more funding resources at their disposal. Another funding option that has gained recent popularity is crowdfunding, which can be a means of distributing equity or essentially a donation with a promise to provide a product or service later. For us, dealing with a large number of shareholders, as well as the time and cost to raise this round, was far too high to be worth it, and this is generally why we've raised capital from accredited investors. However, I want to see more options for access to capital rather than fewer. In that vein, it might be worth seeing if the accredited shareholder

threshold could be reworked to be more flexible depending on the cost of living.

I understand that some regulation is important to make sure investors and entrepreneurs are held accountable. However, overregulation leads to stagnation, decreases in new company formations, and limits deployment of new capital. We have seen that play out over the past few years as regulations have made it harder for businesses to exit. For a company like ours, being able to exit is fundamental to our business plan and affects everything from raising capital to hiring great people. An exit, whether it be a merger, acquisition, or IPO, allows employees to be rewarded for their hard work, investors to be compensated for taking a risk, and founders to capture the capital they need to build the next great company. But most importantly, it is one of the keys to sustainable economic growth.

Early stage investment is critical for building a highly competitive economy. Entrepreneurs already face long odds and we need to avoid adding unnecessary costs and overburdensome government rules. You are in a key position to make sure America continues to be a place for new ideas and innovation. Ensuring the path is clear for entrepreneurs to access alternative financing options is an effort I am honored to be a part of. Thank you for this opportunity and I look forward to your questions.

Chairwoman VAN DUYNE. Thank you very much. I now recognize Ms. Kennedy Thompson for her 5 minute opening remarks.

STATEMENT OF MARY KENNEDY THOMPSON, COO, NEIGHBORLY

Ms. KENNEDY THOMPSON. Good morning, Chairwoman Van Duyne, and distinguished Members of the Committee. My name is Mary Kennedy Thompson and I am the Chief Operating Officer of Neighborly, a family of home services companies with more than 5,800 franchises serving 12 million customers across six countries. We specialize in repairing, maintaining, and enhancing people's homes and properties worldwide. It is my honor to be here today to give you my perspective on the impact alternative areas of financing can have on small businesses, especially franchisees, franchisors, and their employees.

I appear before you today on behalf of the International Franchise Association, or IFA. IFA members include franchise companies in more than 300 different industries and individual franchisees that support nearly 8.7 million direct jobs. Today, I will tell you more about Neighborly and franchising in general. I will also share how some of the ways non traditional financing, such as through private equity, helps grow brands and companies faster and smarter. I believe franchising is the greatest democratization of wealth creation that exists today.

I have spent more than three decades in franchising, both as a franchisee and a franchisor. Before my career in franchising began, I served 8 years in the Marine Corps as a United States Marine Corps Officer, including being the first female Platoon Commander for my unit. When I returned home to Texas after serving time in the Marine Corps, I wanted to own my own business. I wanted to take control of my own destiny and serve my community. But I had

no business experience and I knew I needed help if I was going to make my dream come true. In 1994, I got my start as a franchisee in the Cookies by Design system and I have grown in franchising ever since. The franchise model empowered me, someone with no business experience, to start my own business with the guidance, resources, and assistance I needed to be successful. With that success, I was able to create hundreds of jobs in my community.

With my role in Neighborly, I now help new franchisees under all 30 of our brands achieve their business dreams of owning their own destiny, just as I did 30 years ago. Our mission at Neighborly is to teach our principles and systems of personal and business success so that all people we touch live happier, more successful lives. We do that by teaching the franchise system, including how to run a business well, how to take care of customers, serve the community, and create jobs. Now, we don't employ, hire, or fire our franchisees employees. It is not the role of the franchisor to get between a franchisee and their employees. Rather, our role is to share with franchisees our knowledge and experience to ensure that they are doing it the best possible way and that they are growing their businesses.

I have lived the American dream of being an entrepreneur and helping grow and scale businesses, but it would not be possible without alternative forms of capital. Private equity, for me, has been a catalyst for growth and for many of our franchisees and Neighborly. In the past years, small business owners like me, when I was wanting to franchise, we could depend on our local bankers and community banks to be a willing partner, providing capital at reasonable interest rates and an ally throughout the many steps of growing a business.

But in the era of consolidation and mega mergers, this breed of bankers faded away, and they are less concerned with growing their local neighborhood Glass Doctor, for example. Many of our franchise owners don't speak the language of high finance. They are small business owners. Many without college degrees. There is a divide in the business world between the elite and these small business owners who are important part of their communities. They may not know where to go to get financing, to grow their businesses, or to secure favorable rates.

This is where private equity has become an asset to our franchise owners. Private equity brings their experience across various sectors to help franchise owners make informed decisions and stay ahead of the curve. Most importantly, private equity can serve as an effective liaison to the banks, to financing, and to other investors. They give our franchise owners instant credibility and connections. Private equity shops can serve as translators for our owners, connecting those with capital to those who need it. The benefits of private equity networks also extend well beyond financial backing. They open doors for our franchise owners and help them connect to potential clients, suppliers, and other businesses within the portfolio. These relationships can supercharge in terms of new partnerships, joint ventures, and new market opportunities. They are effective thought partners helping grow these small businesses.

Now, private equity nor additional working capital isn't the silver bullet. I tell all my franchise owners they need a strong founda-

tion and a vision for the future to maximize what private equity can do in their business. When a franchise owner gets the right thought partner, private equity can be the rocket fuel that takes their business into the stratosphere. And with that growth comes increased jobs in their communities. Madam Chair, thank you again for the invitation to speak on behalf of small business owners everywhere. I look forward to answering any questions you may have.

Chairwoman VAN DUYNE. Thank you very much. I now recognize Mr. Kress for his 5 minute opening remarks.

STATEMENT OF JEREMY KRESS, ASSISTANT PROFESSOR OF BUSINESS LAW, UNIVERSITY OF MICHIGAN, STEPHEN M. ROSS SCHOOL OF BUSINESS

Mr. KRESS. Chairwoman Van Duyne, Members of the Subcommittee, thank you for inviting me to testify at today's hearing. By way of background, I am an Assistant Professor of Business Law at the University of Michigan, Stephen M. Ross School of Business. My research focuses on bank regulation. Prior to entering academia, I was an attorney at the Federal Reserve Board, where, among other things, I worked on implementing the Dodd-Frank Act and the initial Basel III capital rule.

Small businesses are the lifeblood of the American economy. Indeed, small businesses create more than two thirds of new jobs in the United States and account for almost half of U.S. GDP. On a personal note, one of the things I love most about my hometown of Ann Arbor is the thriving community of small businesses like Zingerman's Deli and Argus Farm Stop that give the city its unique college town feel. In light of the essential role small businesses play in local communities and the national economy, it is critical that policymakers ensure that entrepreneurs have access to funding to establish and grow their businesses.

I will make four points in my testimony today. First, policy responses to the 2008 financial crisis have helped promote small business credit availability by enhancing the resilience of the banking system. Since Dodd-Frank and Basel III were enacted, small business lending has grown at a robust pace. Indeed, the implementation of these new safeguards coincided with the longest U.S. economic expansion on record. This experience confirms that strong bank capital requirements are consistent with long term credit creation, economic expansion, and small business growth.

Second, the Basel III Endgame capital rule, proposed last year by the Federal Banking Agencies, will further bolster the banking system and will not impair small businesses access to credit. There are two specific reasons why Basel III Endgame will not harm small businesses. First, the proposal applies to only the 37 largest U.S. banks with more than $100 billion in assets. These banks focus far less on small business lending than local community banks, which tend to specialize in small business lending and which are unaffected by the Endgame proposal. Second, most of the capital increase in the Basel III Endgame proposal is associated with large banks' trading and fee generating business lines, not their lending activities. The rule could, in fact, encourage large

banks to put relatively greater emphasis on small business lending as they reorient toward less capital intensive activities.

Third, when small businesses have trouble obtaining bank financing, bank consolidation and lax merger oversight often are to blame. The U.S. banking system has experienced dramatic consolidation over time. Regrettably, small businesses suffer when banks consolidate. Since larger banks tend to favor larger borrowers, bank mergers create barriers to entry for new entrepreneurs. Numerous empirical studies have documented a reduction in small business lending associated with bank mergers. For small businesses that are able to obtain loans following a bank merger, credit becomes more expensive, average loan size declines, and non-price loan terms, such as collateral requirements, become more onerous. Despite the harmful effect bank mergers have on small businesses, policymakers have to date done little to stem the tide of bank consolidation.

Fourth, alternative sources of small business financing, such as private equity, private credit, and venture capital may benefit certain small businesses, but they also pose potential risks and must be overseen accordingly. When structured with appropriate guardrails, private capital can create new pathways for small businesses to grow. However, policymakers and small business owners should approach private capital with caution.

Based on the minimal data available, private investors appear to focus on the same types of businesses that already have access to capital. Thus, private markets may be ill suited to reduce barriers to financing for underserved small businesses, including minority- and women-owned companies. In addition, the interests of private investors are not necessarily aligned with those of a small business's owners, its employees, or its community. Since private investors typically have a limited time horizon, they may pursue short term profits by liquidating a business's assets, reducing long term capital investments, loading up the company with debt, or paying out profligate dividends. While these strategies may be detrimental to a small business's long term prospects, they are often profitable for the private fund that intends to exit its investment after just a few years.

In closing, I am grateful for the opportunity to discuss these important issues with you today. Thank you, and I look forward to your questions.

Chairwoman VAN DUYNE. Thank you very much. We will now move to the Member questions under the 5 minute rule, and I will now recognize myself for 5 minutes.

Mr. Shah in the private equity space, merger and acquisition transactions are a vital tool to help businesses expand into new geographic markets. They also help fuel innovation and lower prices. While most mergers do not require additional information once a premerger notice is filed with the FTC and DOJ, a small percentage are subject to additional review out of fear of possible antitrust harm. In your testimony, you mentioned that you are concerned with one of the newer FTC proposals that would subject every premerger notice to additional review, which would force small businesses to spend a lot more time and money on providing likely

unnecessary documentation. So do you believe that this will affect one's ability to find alternative financing, and if so, how and why?

Mr. SHAH. Thank you for that question. Yes, I do. I believe that because when you are starting a business, specifically small businesses that are in technology and software that are very high fast growth companies, and it is required to go after private financing, such as, like I said, angel investing, venture capital, it is important that we have an exit strategy. And if that exit strategy by any means is compromised or could be compromised even the eyes of an individual, a fund, society in general, then it definitely impacts us for the ability to raise that capital.

Any additional regulation—we don't know as entrepreneurs when this exit is going to happen. We can't predict that. I wish I could. And we don't know where it is going to come from. And if we have the opportunity for an exit that meets the requirements of all of our shareholders as well as our employees, and it is then come to where additional paperwork is required. And from that additional paperwork, it may even mean that we are not allowed to merge or allow to be acquired due to antitrust laws. It can have a ripple effect in our business plan and the ability for us to continue to raise additional capital to run our business.

Chairwoman VAN DUYNE. What I have heard over and over again is that businesses are happy to play by the rules, but they need to know what they are.

Mr. SHAH. Absolutely.

Chairwoman VAN DUYNE. When they are continuously changing, it is very difficult to have an exit strategy or build a business model around that. Can you kind of expand a little bit on what you are seeing in that industry, in that area?

Mr. SHAH. Yes. I think a lot of people might think we're a lot smarter than we are and the reality is we're not. We find a problem in the world, we go out and solve it, and sometimes that solution works and sometimes it doesn't. But when that solution works, we need the ability to go after it with all of our might and power to see if it is successful. And because of that, we don't know where that financing is going to come from.

We know how to grow the business. We know the right talent to bring on a lot of times, but we don't know how to get that exit. And that exit is critical, again, to the way that we raise capital. A lot of the private markets require us to have an exit because that is how that capital goes back into the economy and grows more small business owners. And I include employees in this, and I think a lot of people forget employees because, especially in the tech sector, employees have stock options and they are tied to the business. And when the business exits, they are able to also get a substantial reward and help new small businesses.

Chairwoman VAN DUYNE. Thank you. Ms. Kennedy Thompson, in April last year, the SBA under the Biden Administration made a number of rule changes to some of its biggest lending programs, including the 7(a) and 504, which franchises heavily utilize. Among those changes was the elimination of the franchise directory in an effort to simplify affiliation determinations. Can you speak to how the SBA's rules change to eliminate the franchise directory has or could impact access to capital for franchisers?

Ms. KENNEDY THOMPSON. Yes. Well, anytime—you talked about this earlier, anytime there is change, and it creates uncertainty. And the first thing it does is it makes the business owners decide maybe not to grow anymore where they are. They think, you know what? There is so much work, I have taken so much work to get to here, to get to the next place. I am not sure I understand it, and I am not sure I am willing to take that risk. And so, change puts this uncertainty in the business owner, especially the small business owner's mind, that causes them to not grow, to not create more jobs, to not be able to serve the customer in the best possible way. So that is the first thing.

The second thing is that when it changes, it is not like there is a big edict that goes out to everybody and says, this is how it is changed. This is what you need to do. This is how you get here. This is what you need to do next. They do not understand it. They do not know who to talk to. They do not know what to do next. And it just slows down growth completely. And for what I look at, and I grew up in a very small community. Every small business we have in that community, every franchisee in that community, is an important part of creating jobs for what we do. And if we cannot grow them, because they do not know with the changes in how the SBA is lending, one of the things that we see is SBA is pretty good at getting somebody the funding when they are just opening. But when they go to expand, the rules are so onerous, they cannot figure out how to get more funding to expand.

Chairwoman VAN DUYNE. Thank you very much for that. We are now going to go on and recognize some of our other Members who've got questions. And I now recognize representative Crane from Arizona for five minutes.

Mr. CRANE. Thank you so much for holding this hearing today, ma'am. Thank you guys for coming. Ms. Thompson, thank you so much for your service. We appreciate it. Have you guys noticed that because of the uncertainty of some of the regulations that have been coming down from this administration, a lot of entrepreneurs will just completely go around or forego even talking to some of your more traditional resources for gaining capital? You were talking about seed investing, angel investing. Have you noticed that a lot of entrepreneurs will just go straight to those sources instead of going to banks and the SBA?

Mr. SHAH. Yes, I have definitely noticed a lot more of that. I can say from my perspective and the type of businesses that I have run in the technology sector, where it is software based, it is extremely difficult, if not almost impossible to go get traditional lending because we do not have physical assets, such as a physical location, physical assets, they do not really deem software as something that is able to be collateralized. So, it is very, very difficult. And so therefore, private equity, whether it is angel investors, seed rounds, or venture capital, is just the route you have to take, and there isn't really a lot of other financing options.

Mr. CRANE. Yes. Thank you. Ms. Thompson, how is it in the record high inflation that we are seeing right now? How is that affecting your franchises that you represent?

Ms. KENNEDY THOMPSON. It is affecting them on just about every single level. Their supplies have gone up dramatically. They

cannot pass those costs on to the customers in the right price increases that they need to access to capital is costing them more. That is why I am here talking to you about private equity, because it is proven to be a good source of finding capital for our franchisees. It is costing them more on how they are engaging and hiring employees. It is costing them on what their rent is.

Mr. CRANE. Yeah.

Ms. KENNEDY THOMPSON. And in every way, it is affecting their profitability.

Mr. CRANE. Have you seen it stopping growth within the franchises that you represent?

Ms. KENNEDY THOMPSON. Yes, I have. I have seen it in people wanting to expand because the interest rates are too high or the cost of the supplies are too high for them. And so right now they are holding. They are holding and waiting to see what is going to happen next.

Mr. CRANE. So a lot of people do not understand the trickle-down effect in a business because they have never owned a business. When business owners start to feel pinched, how does that affect the people that many of us here represent, you know, the average American citizen. Does it mean they do not get raises anymore? Does it mean they get laid off? How does that affect the little guy out there?

Ms. KENNEDY THOMPSON. Well, when you see things like the inflation we are seeing now, first of all, it means fewer jobs, because probably one of the best job creators out there are small businesses, and they stop hiring. And then if the costs get too much and they think they have to pull back, then they actually do layoffs as well, and they cannot do the raises for everyone the way they would need to, and they cannot put money back in their community. Small businesses are probably some of the best groups of individuals that give back to their communities, both philanthropically and in other ways, and they cannot do that either. But I think the biggest thing is it means fewer jobs out there.

Mr. CRANE. What about crime, Ms. Thompson? Have you seen crime heavily influence and affect the franchises that you represent?

Ms. KENNEDY THOMPSON. Yes, we have. It is interesting. Most of my franchise owners will have between three and seven vans that go out and service customers. We used to see, per franchise owner, maybe one van every couple of months that would be broken into. It is a weekly occurrence for our franchisees now. They have to have extra security, which, of course, costs them. They come in and their van is broken into, all their equipment is gone, and then the new equipment they have to buy costs even more than what they originally had.

Mr. CRANE. Yeah. Besides imposing regulations that prevent access to capital, what other regulations are you guys seeing out there on the ground from this administration that are affecting small businesses?

Ms. KENNEDY THOMPSON. The one that really worries me is the Congressional Review Act. It has the potential to completely undermine the franchise business model. The National Labor Relations Board, or the NLRB, has issued a final rule on a joint em-

ployer standard that would reverse this course back to the harmful 2015 version. This takes away the equity and the independence of the small business owners. And I would like to remind most that many of our small business owners are women, people of color, and veterans. While the average business, small business in the United States has 17 percent, people of color running that or owning their business in franchising is 26 percent.

Mr. CRANE. Thank you for bringing that up, ma'am. I appreciate it, and I yield back.

Chairwoman VAN DUYNE. All right, we are going to go ahead and go into a second round of questions I wanted to ask you, Ms. Kennedy Thompson, if you would mind just, kind of, following up a little bit. You have talked about some of the experiences that you are seeing in general. But specifically for your experience, how has private equity helped grown your business, your franchise? What have you seen?

Ms. KENNEDY THOMPSON. Yes. So, on the franchisor level, we also have private equity sponsorship. And I can tell you, when I started in this company, we had six brands, and today we have 30 brands. We went from doing 400 million to 4 billion. And it is a direct relationship to the sponsorship, thought-partnership, and help that we have gotten from private equity. They put the right resources to help us find great talent; the right resources to get us the right capital to be able to acquire companies and grow and better serve our customers. Because you can imagine in the home services, I might not always need a plumber, but I do need a plumber, and a maid, and I need my sidewalks cleaned, and I need my windows cleaned. And so, it allowed us to better take care of our customers by being able to build this company that has all the things to repair, maintain, or enhance their home or property. And then for us, you are only as good as the people that you have on your team. And they have helped us really find great talent to be able to serve our franchisees in the best possible way to support them and help them grow their businesses.

Chairwoman VAN DUYNE. Thank you very much. Mr. Shah, have you had to make any adjustments to your business operations or strategy to comply with regulatory requirements, either with private equity or with private credit?

Mr. SHAH. We haven't done too many adjustments yet. However, because of new regulation, we have seen a number of new types of private financing occur. Different types of debt financing, convertible note financing, just different type of private markets to make it easier to raise capital in the financing markets without having to potentially provide all of the information at the level we are at. Providing a lot of this information and data, it is a lot of cost early on to a small business, a lot of legal fees that we cannot afford. And so, we have had to have, kind of, become smart and raised capital in different ways.

Chairwoman VAN DUYNE. We have heard from business owners that geographic location is a major limiting factor when trying to access venture capital financing. Have you encountered this issue, and if so, what do you think can be done to expand these options outside of Silicon Valley?

Mr. SHAH. Absolutely. I have faced these issues lots of times. I lived in the Midwest my whole life, and I love the Midwest. But it is very difficult to raise capital for software tech companies there compared to the coast, especially in Silicon Valley. We have, thankfully, successfully raised financing from Revolution Rise of the Rest here in D.C., and their entire mission is around making it more accessible for venture capital throughout the non-Silicon Valley, Boston, New York, sort of hotspots.

One of the things that we can do is by making it—adding regulation that allows for more credits to occur or matching programs to occur between investors and entrepreneurs that are starting businesses. As I mentioned earlier and in my written testimony, it is very difficult for us to get traditional financing, whether it be SBA or via a traditional bank. And so, to offer alternatives to allow for that to be easier and risk to occur to start these small businesses, I think would be a long way forward in helping more cities gain exposure.

Chairwoman VAN DUYNE. Excellent. Thank you very much. I now recognize Rep. Gluesenkamp Perez from Washington for five minutes.

Ms. GLUESENKAMP PEREZ. Thank you, Chairwoman, and thank you to our witnesses for being here today. Professor Kress, we know that 40 percent of the nation's small business lending originates from community banks. These banks are an incredible asset for our communities. They know their customers inherently. They know the people around them. But I hear from the small community banks in my district that they can no longer compete given the competition from the big guys. You mentioned that these community banks, which we know serve our small businesses very well, have borne the brunt of banking consolidation trend. You also note that research from the Federal Reserve Bank in Philadelphia has documented that large acquiring banks divert small business lending from their target communities to the acquirers communities, leaving the target communities worse off. So, I wondered if you could talk about the impact of banking consolidation on our small businesses and what should be done to stave off these effects.

Mr. KRESS. Absolutely. Thank you for the question. And I note that Ms. Kennedy Thompson mentioned in her testimony that she and her businesses have felt the effects of bank consolidation as well, because, as you noted, community banks tend to focus much more heavily on small business lending. They engage in what is known as relational lending because small community bankers know their communities. They know the businesses in those communities, they know the local business environment, and so they have the soft information that they are able to use to more accurately underwrite small business loans.

I attribute a lot of the problem to bank consolidation and lax merger oversight; 7500 community banks disappeared due to mergers between 1984 and 2011. Those are 7500 community banks that are no longer able to provide small business loans to entrepreneurs in their areas. The White House issued an executive order on competition in 2021, urging the Department of Justice and the banking agencies to develop a plan to revitalize bank merger oversight. Progress on that front has been slow, but there are encouraging

signs. I think Assistant Attorney General Kanter has outlined a framework for how he might think about promoting competition and focusing in particular on small business lending and protecting that as part of the bank merger oversight process. But maintaining a robust community bank system is absolutely critical to ensure small businesses access to credit.

Ms. GLUESENKAMP PEREZ. Thank you. I am also interested in hearing directly from our small businesses about the options available to both of you. Ms. Kennedy Thompson and Mr. Shah, a question for both of you. You have chosen private equity, venture capital, and other private investment strategies over the course of your career rather than utilizing an SBA structured product. And I wondered, why did you choose a private investment over SBA's guaranteed loans? What barriers or difficulties did you see in working with the SBA?

Mr. SHAH. Thank you for that question. For us, it was simple. We didn't have the collateral that the banks or the SBA required. You have to be either individually wealthy and provide those assets, or you have to have a business that has assets for it to work. And we didn't have either. And therefore, it wasn't an option for us.

Ms. KENNEDY THOMPSON. And for us, it was the speed to market. How fast could we move? How fast could we take care of our franchisees, and how fast could we take care of our customers? And private equity, frankly, allowed us to move faster.

Ms. GLUESENKAMP PEREZ. Hmm, okay. How can the SBA process be improved so more small business owners choose to utilize and view it as a viable option?

Mr. SHAH. I think Ms. Thompson just said it as well, is speed for businesses. Small businesses do not have the time and the luxury to wait, you know, years to figure this out and go through a process of denial where private investors are giving you responses pretty immediate. Even if it is no, it is still pretty immediate. And I think that, again, we need to change the collateral requirements to be more in line with the new economy versus the old economy.

Ms. KENNEDY THOMPSON. One of the reasons that speed is so important as a small business owner is you have to be able to pay yourself. There are three things you have to do. You have to pay yourself. Pay down debt. Put it back in the business. And if you cannot pay yourself, you are not going anywhere. And so, if it takes months and months, you end up having to go do something else.

Ms. GLUESENKAMP PEREZ. Mm-hmm. Yeah, I bought a building. I own an auto repair shop with my husband, and we bought a building with a 504 loan. The only reason it worked was because the sellers, they were committed to seeing that property remain in the trades. And so, you know, God bless them for that. But that is so rare. And we shouldn't—we cannot let our small businesses be at the mercy of someone's good intentions. So, thank you both so much for being here. I yield back.

Chairwoman VAN DUYNE. Thank you. I now recognize Rep. Bean from Florida for five minutes.

Mr. BEAN. A very good morning, Madam Chair. And good morning, Small Business. To our witnesses, welcome. We are glad to

have you here. How bad is it on a scale from 1 to 10, 10 being atrocious, zero, not at all a problem, the regulatory environment? Madam Chair, in her brilliantly debated opening statement, really nailed it with the amount of the regulations that are, that she says strangling small business. Is she on, or is that just made up, all the regulations? So, give me—is it really bad, a scale from 1 to 10, how bad is it, new regulations on small business? Mr. Shah?

Mr. SHAH. I think it is different for every type of small business. We work with a lot of independent restaurant owners, bars, breweries, and I think it is extremely bad for a lot of them.

Mr. BEAN. You would say over what number?

Mr. SHAH. Probably over seven.

Mr. BEAN. Okay.

Mr. SHAH. They are absolutely feeling it right now. For tech companies like ourselves, we also, I would say, are probably a little bit lower just because we have access to different financing options.

Mr. BEAN. Yeah.

Mr. SHAH. But in the last few years, as I have said in my testimony, that has also shrunk. The access to capital has shrunk. With interest rates being as high as they are, there is less capital being deployed in the private markets as well.

Mr. BEAN. Seven.

Mr. SHAH. And so——

Mr. BEAN. Seven.

Mr. SHAH.—that is affecting us a lot——

Mr. BEAN. Ten-four.

Mr. SHAH.—at the moment.

Mr. BEAN. Ms. Thompson, what say you?

Ms. KENNEDY THOMPSON. Well, I was thinking a seven.

Mr. BEAN. Seven.

Ms. KENNEDY THOMPSON. And I say the only reason it is not an eight is because we found other ways to work around it. Otherwise, it would be an eight-plus to a nine.

Mr. BEAN. Ten-four.

Ms. KENNEDY THOMPSON. We have got to find ways to get them to move faster.

Mr. BEAN. Gotcha. Mr. Jeremy, what do you say?

Mr. KRESS. I would just note from an access to capital standpoint, that from a data driven perspective, and with all due respect to colleagues who run small businesses, but Fed data show that the growth of bank loans to partnerships and proprietorships has been positive for every year from 2011 to 2021, and it only dipped negative as a result of the pandemic.

Mr. BEAN. What does that mean in a number? On our Bean scale from 1 to 10.

Mr. KRESS. The Fed researchers characterize small business loan growth as robust.

Mr. BEAN. Yeah.

Mr. KRESS. So, looking at it solely through the lens——

Mr. BEAN. Taking that number——

Mr. KRESS.—of that data, I would put it below five.

Mr. BEAN. Below five. All right. Ten-four. I will accept that answer. Why not just go to the bank? Mr. Shah, why can't you just

go to the bank? There is a bank on every corner. Is a bank an option or not an option for capital?

Mr. SHAH. For us, it is not an option because we don't have the traditional capital required. We don't have physical assets. Our assets are code written on a computer. They don't deem that as worth it in terms of loaning against it. Also, in our business, there is a lot of private companies that will loan against revenue or cash flow. But businesses traditionally, or banks traditionally, do not loan against that; they loan against collateral. So, for us, it is really never been an option.

Mr. BEAN. Ten-four. Now, Ms. Thompson, you are in the franchise. I see a hater behind you. You are in the franchise world.

Ms. KENNEDY THOMPSON. I am.

Mr. BEAN. Why can't you go to a bank? Is it, Mr. Shah on that?

Ms. KENNEDY THOMPSON. No. Sometimes we do go to a bank. Sometimes, especially when they are beginning out. What happens, though, is with the mega mergers, those relationships that the local community that we just talked about earlier, they are just not there anymore. And so, they do not go because they do not know where to go and they do not know who to talk to.

Mr. BEAN. Mm-hmm.

Ms. KENNEDY THOMPSON. And they have to find a way to have a relationship with somebody that will help them build their business. And the megabanks, they are not looking at how your profitability and how you are growing. They are just looking at, are you paying the loan down? Whereas private equity, it matters to them where your profitability is because they are not going to be able to exit without a strong profitability. So, there is high alignment.

Mr. BEAN. Gotcha. Is it much more expensive, private equity, Mr. Shah, would you say, is it much more expensive or you just need the capital? We got to go. You got a great idea, you are ready to go. And I sense that time is money to you. Is that correct?

Mr. SHAH. Yeah, but I don't think it is actually more expensive because there is a lot of things, if you choose the right partners in the private equity world, they can actually accelerate your business. Banks, for the most part, aren't going to provide you with advice, expertise, access to other capital, connections in your industry to grow your business. They are just going to provide you the capital, typically.

Mr. BEAN. So it is kind of like Shark Tank. You get somebody that is going to be there and they are going to hopefully work with you.

Mr. SHAH. Exactly. They understand us. A lot of them are former founders. They get that we are going to go through ups and downs, and they are going to be there for us the entire way. Again, you have to find the right partners, but those partners exist.

Mr. BEAN. Gotcha. Ms. Thompson?

Ms. KENNEDY THOMPSON. Mr. Shah said something earlier about how you can also help your employees. What I like about private equity is every single time they have helped us help our employees as well. When we exit, they exit with a strong exit, too. So, we actually get to transform lives.

Mr. BEAN. Ten-four. No, I appreciate that. As a small business owner, formally, it is hard enough when in a perfect environment, let alone when the government continues to put new and harder regulations. So, thank you for being here today. Madam Chair, I yield back.

Chairwoman VAN DUYNE. Thank you. I now recognize Representative Alford from Missouri for five minutes.

Mr. ALFORD. Thank you, Chairwoman Van Duyne, good to see you. Thank you all for being here on your own time and own dime, as I like to say. It is a great investment in Main Street America for you to be here. Small businesses are the fabric of America, and I am proud to be a part of this committee where we are trying to make sure that people have the capital and the resources needed to not only start new businesses, but to maintain them in America.

As you well know, today, businesses are already struggling under rampant inflation, ongoing supply chain issues, workforce shortages, burdensome regulations. On top of these issues, the Biden administration is pursuing antigrowth policies such as Basel III, further shrinking access to capital. President Biden also vetoed partisan legislation that would undo the CFPB's Section 1071 reporting requirements that would further burden small businesses' ability to access capital. With the shrinking availability of capital from the banking industry, small businesses have turned to alternative sources of capital, such as private equity. Private equity is an essential tool for small businesses looking to access capital and actually grow. In our district alone, there was $1.4 billion of private credit investment in 2022.

Unfortunately, the Biden administration cannot abide any pathway for main street to grow and has released a new merger guidelines through the FTC and DOJ that curtails private equity's ability to invest. By the FTC's own estimate, the new merger guidelines would lengthen the process for filing by 300 percent. I feel that is unacceptable.

Over the next decade, compliance with President Biden's regulations will cost Americans more than $1.5 trillion. Let that sink in. Ms. Kennedy Thompson, thank you for being here today, and I like your pink.

Ms. KENNEDY THOMPSON. Thank you.

Mr. ALFORD. Can you please speak about how securing capital from private equity impacted your business?

Ms. KENNEDY THOMPSON. Certainly, I would be most happy to. There is many levels that has impacted us so from the franchisor side. We are in our fifth hold period with private equity. When I came into the company, we were doing 400 million with six brands. Today we are doing 4.1 billion with 30 brands. And it is a testament to the private equity investment that our PE sponsors have made with us and helped us. And along the way, as we have grown, we have been able to grow our franchisees as well because we have had the right resources at the right time to bring in the right talent to be able to have the right access to capital, so we could buy some of those companies to be able to provide our customer the right and best experience.

And then to our franchisees, we have many that are ready to grow, and they are finding access to capital quite difficult. And the

smaller PE companies are coming in and being thought partners to them. Introducing them to the right partners, and to the right suppliers, and helping them grow their businesses as well.

Mr. ALFORD. Very quickly, where would you be today if it weren't for those investments?

Ms. KENNEDY THOMPSON. That is a great question. I certainly don't think we would have 30 brands doing 1 billion. I don't. I was there at the early days, and we are a completely different company with really great resources at our fingertips. And what is most important is it is helping us grow our franchisees.

Mr. ALFORD. Mr. Shah, in your remarks, you spoke about how SBA loans are a key avenue for many businesses to access capital. However, you noted that the majority of these loans require some form of physical asset to secure. How can the SBA better support small businesses in the tech space, such as your own?

Mr. SHAH. That is a great question. I think something needs to change on that side. What they can do is, I think they can use the private markets to understand collateral. So, for example, if you do receive private equity, the SBA can come in and provide additional capital on top of the private capital to further grow that business. There are also ways that we can look at collateral differently today than what historically has happened. You can use revenue growth or traction or other metrics that are not physical assets in the eyes of what I would say is a traditional physical asset. So, I think a lot of those avenues need to change as well.

So, I would say the biggest part for us is the private markets, and allowing us to use the private markets to help with the SBA loans.

Mr. ALFORD. Thank you so much. Thank you again to our witnesses, and with that, I yield back, Madam Chairman.

Chairwoman VAN DUYNE. Thank you very much. I would also like to thank our witnesses for your testimony and for appearing before us today. Without objection. Members have five legislative days to submit additional materials and written questions for the witnesses to Chair, which will be forwarded to the witnesses. I ask the witnesses to please respond promptly. If there is no further business, without further objection, the committee is adjourned.

[Whereupon, at 11:01 a.m., the subcommittee was adjourned.]

APPENDIX

Committee on Small Business
Subcommittee on Oversight, Investigations, and Regulations
Hearing on "Navigating Regulations: Alternative Pathways to Investing in Small Businesses"

Testimony of Parag Shah
Founder, Vēmos
March 12, 2024

Chairwoman Van Duyne, Ranking Member Mfume, and members of the Subcommittee, thank you for inviting me to testify today regarding my experience with alternative financing for small businesses. My name is Parag Shah, and I am the founder of Vēmos, a Minnesota-based company that creates personalized experiences between consumers and hospitality businesses such as restaurants and bars.

Using our app, consumers can view a personalized menu tailored to their allergies and dietary needs, quickly view and pay their bill, while saving their favorite menu items at their favorite spots. Our app helps restaurants better understand their customers and provide a more personalized experience so they can grow their business. Prior to Vēmos, I have started a handful of other technology companies, many of which have failed but a couple of which have succeeded. I am also a proud member of ACT | The App Association, a trade group representing small tech companies like mine.

Based on my experience, there are three concepts I want to highlight for the Subcommittee and other small business owners who may have an interest in these issues:

1. **Alternative financing options** have improved over the past 15 years or so and become better distributed throughout the country;
2. When looking for investors, entrepreneurs should **take time to compare their options;** and
3. **Overregulation and government intervention** threaten our progress on alternative financing in several ways.

Alternative Financing options: an overview

There are several "early-stage" options for securing capital. One route involves private equity, and I know other witnesses at this hearing can cover these scenarios more authoritatively. I have more experience with options like friends and family investment, angel investment, and so-called "seed rounds" of fundraising before a venture-backed Series A or B fundraising round. Although I have never pursued crowdfunding, I can speak to its pros and cons, having seen friends and colleagues make use of it. With each of my companies, I have looked at the needs of my particular business, our strengths, and what we might be able to offer an investor, as well as the economic conditions at the time.

Starting a tech company often involves lower overhead costs than starting a brick-and-mortar retail store or restaurant. For us, the biggest asset has always been our human capital. You can have an idea, find a few cofounders, and get to work on your code without a lot of initial startup costs. The bumps in the road for these small tech companies start when they try to grow that business without money. If they don't have an immediately viable and available client base, they need some kind of investment. This is why alternative financing options are often relatively more attractive for software companies than for other kinds of startups. On the one hand, it usually takes less overhead to start a company, because you don't have to invest in physical inventory or infrastructure. On the other hand, traditional loans usually require physical assets as collateral, and it can be more difficult to create a viable client base with software, although the app stores have helped fast-track the process of acquiring customers.

Back in 2007, I was ready to start my first company. Founders didn't have as many resources then as there are now, so I didn't understand the process as well. Plus, being in Minnesota meant that it was more difficult to find capital since much of it was concentrated on the coasts. After struggling to raise sufficient funds through a seed round—which generally means raising between $1 million and $8 or $9 million, depending on the market—we ended up getting angel investment.

We had trouble finding local Minnesota investors who were willing and able to write checks large enough to make a dent in our seed round. We also made the choice to only work with accredited investors, which means that they have a certain annual income and ability to invest. Eventually, my cofounders and I exited that company through licensing our technology.

Crowdfunding

My current company received venture funding in the form of a seed round. Vēmos is fortunate to be a portfolio company of Revolution's Rise of the Rest, a seed funding effort focused on companies across the country that are not necessarily based in investment centers like Silicon Valley or New York City. Before settling on this deal, we considered other financing options. One option for some businesses is crowdfunding. In my opinion, this type of financing works better for small, physical businesses than it does for tech companies. With crowdfunding that involves an exchange of equity for cash, each investing entity is afforded the same rights as a shareholder, whether they invested $1 or $1 million. Even though federal law does not require these securities to be registered if they're less than $5 million in aggregate, it's really hard to effectively run a company like ours if you have such a large capitalization table (a spreadsheet showing the equity stake each investor owns). Since every name on a capitalization table represents an investor with an equity stake, I am accountable in specific ways to each of them. Having 100 bosses is difficult enough, and even more complicated if some of them have only invested small amounts while others have invested heavily. For their part, higher-level investors are also sometimes wary of those small-dollar funders having equal access and rights to those who have contributed much more.

The other category of crowdfunding is a "donation based" model, which might work better for a business like a coffee shop, or some other service-based business that could offer a non-monetary good or service in return for "donations" received via crowdfunding. You can offer incentives like free coffee for a year for a certain investment, something that's not as easy to do with different types of technology. This would be considered a "donation based" campaign rather than a "securities based" campaign because there is no expectation of profits from a common enterprise and there is an element of consumption. Courts have consistently held that crowdfunding-style capital campaigns are not securities based if there is a consumptive element to the contract, such as in my coffee shop example, or in the example of one lawsuit where people purchased stock in a housing co-op in order to rent apartments. Kickstarter is another good example of a platform that facilitates a donation-based model. Individuals can contribute money toward a board game or piece of technology, with the expectation that they will receive a piece of the thing they invested in. They would not receive shares in the company making the game or the technology. For companies that are looking to increase profit through growth, the donation based model would not apply—investors would be looking for some return rather than effectively donating to a venture.

Regulatory impacts

While some regulation is important to make sure that investors are not being swindled out of money and entrepreneurs can count on their funders to follow through, overregulation leads to stagnation, decreases in new company formation, and limits in deployment of new capital. We have seen this dynamic play out over the past year: less capital was deployed last year than any recent year. Regulations have made it harder for business owners to exit the market, which for someone like me is a key way to build capital in my next company—but for others is their retirement plan.

The Hart-Scott-Rodino Act and related Federal Trade Commission (FTC) actions

One of the most significant proposed rules that I see threatening businesses now is the potential update to the process of filing a premerger notice under the Hart-Scott-Rodino Act (HSR). HSR review requires entities about to enter into a transaction that is over a certain size (currently $119 million) to file a premerger notification with the Department of Justice (DOJ) and Federal Trade Commission (FTC). These agencies work to clear the merger or to determine whether more information is necessary. Most mergers do not require additional information and are allowed to go on as planned, while some that the agencies believe are likely to cause antitrust harm are subject to this additional review. That review requires significant new document production and lawyer hours to answer adequately. And as I'm sure you're all aware, lawyer hours are very expensive, especially for a specialty lawyer like one with extensive merger experience.

There is a change under consideration to require every proposed merger subject to HSR rules to provide the information found in the additional review up-front, even if they would have been

cleared through the initial document production. As a reference, under current rules the vast majority of mergers—about 98 percent—are able to be cleared using just the documentation from the first stage, while the remaining 2 percent that are judged higher risk must produce additional documents. Forcing all prospective mergers to conform to this much higher standard would, frankly, be a waste of time for all parties involved. For small companies, who would have to spend many more hours and much more money on this unnecessary documentation, this change would also affect their ability to be acquired by making it much less attractive for larger companies to consider an acquisition.

The HSR proposal is just the latest in a series of actions at the FTC that are making it harder to be acquired. Beginning three years ago, the FTC already decided to stop issuing letters letting merging parties know their review is over (and therefore that it's safe to merge unchallenged); began sending "warning letters" saying investigation is ongoing even after expiration of the review period; and issued merger guidelines declaring a wide range of mergers to be presumptively illegal. Taken together, all of these updates send strong signals to potential acquirers not to bother with it.

Even for companies that do not have a valuation of higher than $119 million (the current HSR threshold), their value decreases as well, as the market generally for acquisitions slows down under the weight of the additional red tape and uncertainty placed on the larger acquisitions. Entrepreneurs like me use acquisitions and other types of exits to fund new companies, and some business owners use acquisition as a retirement plan. But the resulting depression in value of companies like mine also means that my other options are less attractive; if my company is less valuable, investors are going to give me worse terms in any financing vehicle under consideration. Whether or not it's too uncertain or expensive to acquire my company has an impact on that valuation and on my bargaining position. In turn, this has a reverberating effect on my ability to find viable alternative financing.

I do not worry much about the failure of my company due to strong competition or tough market conditions. I've started up successful companies, and I can do it again. I do, however, worry about regulatory interventions like this that can short-circuit the cycle of creation that I thrive on.

Regulation D

The Securities and Exchange Commission's (SEC's) Regulation D is a rule that governs the private placement of stock. Private placement is an alternative to an initial public offering (IPO)—something that is out of reach for many small businesses—that allows companies to pre-select investors and offer equity to raise capital. There are fewer regulatory requirements on private placement than on an IPO, which makes them easier for small companies to do while still leaving open the door to an IPO at a later date. Through Regulation D, buyers are still allowed the same legal protections as other investors while companies can have more flexibility in raising funds.

One of the largest limitations on Regulation D investment is the requirement that most investors be "accredited investors." This means that issuing companies have to do some due diligence to discover whether their investors are accredited or not. Companies may sell securities to up to 35 non-accredited investors, but those investors must be considered "sophisticated," meaning they must be able to evaluate the risks and rewards before investing. Again, this requires some due diligence and being able to show that you looked into whether the investor is sophisticated. Additionally, the threshold for accredited investor is one-size-fits-all: it's the same number regardless of where the investor lives. As a result, the threshold may be unreasonably high for areas with much lower cost of living than is found in densely populated urban centers where the $200,000 income requirement is more commonly met. Some prospective investors may be barred from private placement by Regulation D because of this rule, but in my experience restricting investors to only accredited investors has helped ensure all parties are protected. Similarly, as described above, sticking with investors that are clearly able to "fend for themselves," like accredited or corporate investors, helps keep my capitalization table uncomplicated. As much as I believe my companies deliver value for our investors, it's important that they have support if something goes wrong.

Small Business Administration loans

Small Business Administration (SBA) backed loans are a key avenue for many businesses to access needed capital. They are very low-interest loans, allowing businesses to fully invest in their ideas and growth instead of worrying as much about repaying interest. I know that other members of the App Association have successfully leveraged SBA loans in growing their companies. SBA guarantees several types of loans, including microloans, working capital loans, refinancing of business debt, and other options that are flexible for a business's needs.

A major limitation to SBA loans is that, consistent with traditional loans, they require some form of physical asset to secure. For brick-and-mortar businesses, this is less of a problem, but for businesses like mine that deal almost entirely with software, the physical asset requirement is not a great fit. I wonder if other avenues could be explored for businesses like mine that fit the software model a little better but provide similar benefits for small software companies. For example, some states have "angel tax credits" that allow angel investors to claim a credit for some of their investment in a business. Angel investors do make use of some federal incentives including those related to capital gains or to write off investment losses. However, a federal version of credits for angel investments themselves might also help encourage investment in your congressional districts and in areas that have seen little or no startup investment by locals.

Conclusion

Our current system has a number of avenues businesses can travel to access growth capital, from crowdfunding to private credit to private placement of securities. All of these options have regulations in place to protect investors and businesses, but in some ways those regulations can impede the normal flow of capital. We should consider the impact each regulation has on small

businesses especially, and look for ways to make starting, growing, and selling businesses easier for everyone. I believe this cycle of creation is our secret sauce, and I appreciate the opportunity to participate in the policy debate about how best to protect and improve it.



MARY KENNEDY THOMPSON

COO
NEIGHBORLY

TESTIMONY BEFORE THE HOUSE SMALL BUSINESS SUBCOMMITTEE ON OVERSIGHT, INVESTIGATIONS, AND REGULATIONS

HEARING ON *"NAVIGATING REGULATIONS: ALTERNATIVE PATHWAYS TO INVESTING IN SMALL BUSINESSES"*

MARCH 12, 2024

Good morning, Chairwoman Van Duyne, Ranking Member Mfume and distinguished members of the Committee. My name is Mary Kennedy Thompson and I am the Chief Operating Officer of Neighborly, a family of home services companies, with more than 5,800 franchises serving more than 12 million customers in six countries. We specialize in repairing, maintaining and enhancing homes and properties worldwide.

It's an honor to be here today to give my perspective on the impact alternative areas of financing can have on small businesses, especially franchisors, franchisees, and their employees.

I appear today on behalf of the International Franchise Association (IFA), the world's oldest and largest organization representing franchising worldwide. IFA works through its government relations and public policy, media relations, and educational programs to protect, enhance and promote franchising and the approximately 806,270 franchise establishments that support nearly 8.7 million direct jobs, $858.5 billion of economic output for the U.S. economy, representing almost 3 percent of the Gross Domestic Product (GDP). IFA members include franchise companies in more than 300 different business format categories, individual franchisees, and supplier companies that support the industry.

Today, I will tell you more about Neighborly and franchising generally, and also share how some of the ways nontraditional financing, such as via private equity, can help companies grow their brands and companies faster and smarter. I believe franchising is the greatest democratization of wealth creation that exists today.

The unique franchise business format

Franchising is perhaps the most important business growth strategy in American history. The first franchises started in the colonies by Ben Franklin, and over the centuries, this system has served as a core American model of opportunity and entrepreneurism. In 1731, Ben Franklin entered into a partnership with Thomas Whitemarsh, who franchised his printing business – *The Pennsylvania Gazette*. Later, Whitemarsh would introduce the first "franchised" newspaper of South Carolina, the *South Carolina Gazette*.

Franchising has contributed to robust job creation and provided foundational skills development for small business owners and their workers. Today, there are more than 800,000 franchise establishments, which support nearly 8.4 million jobs.[1] Many people, when they think of franchising, focus first on the law. While the law is certainly important, it is not the central thing to understand about franchising. At its core, franchising is about the relationship the franchisor has with its franchisees—how the franchisor supports its franchisees, the franchisor's brand value and how the franchisee meets its obligations to deliver the products and services to the customers using the system's brand standards.

The value of franchising is supported by empirical data. A recent study by Oxford Economics found that franchising offers a path to entrepreneurship to all Americans, but especially to minorities and women. Around 26% of franchises are owned by people of color, compared with 17% of independent businesses generally. In addition, franchising offers the opportunity for business ownership that would not otherwise be available, especially to women, people of color, and veterans.[2] Franchises businesses also perform better and provide better pay and benefits than

[1] Franchiseeconomy.com (2021).
[2] The Value of Franchising. Oxford Economics (2021)

their non-franchised counterparts. On average, franchises report sales 1.8 times as large and provide 2.3 times as many jobs as non-franchise businesses. Sales and jobs in franchised businesses exceed non-franchised businesses across all demographic cuts, including gender and race. For example, Black-owned franchise firms generate 2.2 times as much in sales compared to Black-owned non-franchise businesses, on average.

Despite how it is often characterized, franchising is not an industry. Franchising is a business growth model used *within* nearly every industry. More than 300 different sectors are represented in franchising, and franchise companies offer a huge range of products and services from lodging to fitness, home services to health care, plumbing, pest control, restaurants, security, and lawn care.

Further, despite popular misconceptions, franchising consists of far more than merely the "fast food" industry. In fact, 63% of companies that franchise are not in the food services at all, and 83% are not in fast food.[3]

There are two principal explanations given for the popularity of franchising as a method of distribution. One is that it "was developed in response to the massive amounts of capital required to establish and operate a national or international network of uniform product or service vendors, as demanded by an increasingly mobile consuming public."[4] The other is that franchising is usually undertaken in situations where the franchisee is physically removed from the franchisor, giving autonomy to the franchisee to run their own day-to-day business operations. These two motivations are consistent with a business model in which the licensing and protection of the trademark rests with the franchisor, and the capital investment and direct management of day-to-day operations of each franchise unit are the responsibility of the franchisee who owns, and receives the net profits from, its individually owned franchise unit.

It is typical in franchising that a franchisor will license, among other things, the use of its name, its products or services, and its operational processes and systems to its franchisees. The turnkey nature of operating a franchised business is why I and so many of my fellow franchisees purchased a franchise. Franchisees look to the franchisor to protect the trade names, trademarks and service marks (collectively the "Marks") and brand by establishing and enforcing standards on all franchisees in a system. Such standards are essential for protection of franchisees' equity in their businesses and consumers of the brand. These standards allow franchisors to maintain the uniformity and quality of product and service offerings and, in doing so, to protect their Marks, the goodwill associated with those Marks, and most importantly, consumer confidence in the Marks and brand. Because a core principle of franchising is the collective use by franchisees and franchisors of Marks that represent the source and quality of their goods and services to the consuming public, action taken to control the uniformity and quality of product and service offerings under those Marks is not merely an essential element of franchising, it is an explicit requirement of federal trademark law under the Lanham Act.

My Franchise Business Story

I have spent more than three decades in franchising, both as a franchisee and a franchisor. Before my career in franchising began, I served for eight years as an officer in the US Marine Corps, including as the first female platoon commander for my unit. When I returned home to Texas after

[3] FRANdata research. (2021).

[4] Kevin M. Shelley & Susan H. Morton, "Control" in Franchising and the Common Law, 19 Fran. L. J. 119, 121 (1999-2000)

my time serving in the Marine Corps, I wanted to own my own business, take control of my destiny, but I had no business experience and knew I needed help if I were to make that dream come true.

In 1994, I got my start as a franchisee in the Cookies by Design system and have grown in franchising ever since. The franchise model empowered me, someone with no business experience, to start my own business with the guidance, resources, and assistance I needed to be successful. After selling by locations, I went to work at the franchise headquarters and went on to become President of Cookies by Design. After being recruited to the Dwyer Group, now re-branded as Neighborly, I served for nine years as President of the Mr. Rooter brand within the group and also as the Vice President for International Relations.

I'm here today as the COO of Neighborly, which began in 1981 with just one brand and is now the holding company for 30 home service-based franchise organizations in the United States.

In my role with Neighborly, I help new franchisees under our brands achieve their business-owning dreams—just as I did more than 30 years ago. Our mission is to teach our principles and systems of personal and business success so that all people we touch live happier, more successful lives. I do this by presenting and teaching the franchise system, including how to best run a business, take care of customers, serve the community, and create jobs. We don't employ, hire, or fire our franchisee's employees. It is not the role of a franchisor to get between a franchisee and their employees. Rather, our role is to share with franchisees our knowledge and experience to ensure that our franchisees are doing the best possible job running their franchise to protect our brands.

Neighborly specifically operates with the core values of respect, integrity, and customer-first. As a veteran, I'm incredibly proud of our work for veterans. Neighborly is the founding company of the Veterans Transition Franchise Initiative, or VetFran. VetFran is an effort by more than 500 IFA member companies to encourage franchise ownership by offering financial incentives to honorably discharged veterans. The VetFran program has led to countless veterans becoming franchise business owners since the initiative was launched in 1991. To date, Neighborly has brought in more than 750 veterans to become business owners receiving more than $5 million in discounts on their franchise fees.

Franchising is an interdependent relationship in which the franchisor licenses to the franchisee the right to use its trademarks, intellectual property, and business and operating plans in exchange for a fee. Through this system, both parties win. The franchisor can expand more effectively than through corporate ownership, and the franchisee is able to be his or her own boss while using a proven operating system. We like to say that franchising allows you to be in business for yourself, but not by yourself.

The system works through mutual dependence that requires close collaboration between the franchisor and franchisee. I've been on both sides of the relationship, and I can tell you that communication and trust are critical for success. We provide resources to help our franchises address some of their most pressing challenges. Recruiting and hiring good people, for example, is an enormous challenge for franchisees, many of which are small, with fewer than 10 employees. Franchisors like ours have historically been able to provide assistance in identifying good people and helping effectively train those workers. Franchisees get the valuable experience of running their own business, while having the franchisor's assistance to provide the resources and support they need.

SBA Lending

The Small Business Administration (SBA) and its lending programs and the access to capital they provide are a big part of the franchise success story. About 20% of SBA lending goes to franchising. In 2022, about 7,000 loans were approved in the 7(a) and 504 programs representing more than $5 billion of loan volume and supporting more than 100,000 jobs.

Last year, the SBA finalized a number of changes to its affiliation rules, including elimination of the concept of affiliation by control, which also resulted in elimination of the Franchise Directory.

The IFA supports efforts to streamline government-supported lending programs and recognizes this was the intent of eliminating the principle of affiliation by control in the SBA size standards, which in the case of a franchise is currently based on franchise agreements. Those determinations required, by their very nature, subjective assessments of contract language. As such, consistency of those determinations, delays in approvals created by occasionally lengthy reviews, and the back and forth with franchisors to reach acceptable agreement language all were impediments to franchisees being able to access the capital they needed to grow. We commend the SBA's desire to address these issues and believe this is a good effort to do so.

However, as part of the affiliation review and use of the Franchise Directory, the SBA conducted an eligibility review, an effort to help lenders from an efficiency standpoint. Unlike other businesses, in franchising there is a set of agreements between a franchisor and the small business franchisees that borrow using SBA-guaranteed loans. In essence, it is a one-to-many review. One-time eligibility review decisions eliminate the need for each lender to review the sometimes lengthy and complicated agreements to assess eligibility. Importantly for franchisors, such reviews avoided the problem encountered years ago where they got inconsistent and often conflicting decisions and requirements from various lenders.

IFA's understanding of the affiliation change now shifts this burden to lenders. This shift may create an inefficiency that will put many franchise brands at a disadvantage. IFA is particularly concerned about access to capital for emerging brands (of which there are hundreds each year) and smaller, regional brands. Will a community bank be willing to make a loan to a franchisee associated with a brand that requires the banker to wade through multiple franchise documents to determine eligibility? Most franchise loans are relatively small, averaging under $400,000. The economics for lenders doing only one or a few franchise loans may drive them away from franchise lending completely.

We appreciate the Committee's attention to this issue given how critical SBA lending is to new franchisees. Banks and borrowers are still adapting to these changes. We are closely monitoring marketplace realities and look forward to continued dialogue with you on this.

Alternate Forms of Capital to Help Franchise Businesses Grow

As I shared earlier, I'm no shill for private equity, I am a Marine. But I have lived the American Dream of being an entrepreneur and helping grow and scale businesses. This would not be possible without alternative forms of capital.

Private equity has been a catalyst for growth for me and many of Neighborly's franchise owners. In years past, small business owners like me when I was a franchisee could depend on their local bankers and community banks to be a willing partner, providing capital at reasonable interest rates

and an ally throughout the many steps of growing a business. But in the era of bank consolidation and mega-mergers, this breed of banker has faded away. And they are less concerned with growing their neighborhood Glass Doctor.

Furthermore, many of our franchise owners don't speak the language of high finance; they're small business owners, many without a college degree. There is a divide in the business world between the elite and these small business owners who are part of their small and mid-size communities. The small business owners may not know where to start to get financing to grow their business or might not be able to secure favorable rates. But this is where private equity has become an asset to our franchise owners.

Private equity acts as a thought partner for our franchise owners – they often have real-world business experience and then can apply this knowledge to help our partners grow. Small private equity shops make their living by identifying under-utilized businesses and helping them develop. They can serve as a sounding board on best practices and practical growth strategies. They offer strategic advice on how to set long-term goals and navigate industry trends. Their experience across various sectors can help franchise owners make informed decisions and stay ahead of the curve. They help our franchise owners grow every step of the way.

Additionally, private equity can serve as an effective liaison to the banks and other investors. They give our franchise owners instant credibility and connections. As we've established, there can be a language divide between small business owners and modern bankers. Private equity shops can serve as translators for our owners, connecting those with capital to those who need it.

Private equity networks extend beyond financial backing. They open doors to our franchise owners and help connect them to potential clients, suppliers, and other businesses within their portfolio. These relationships can super charge growth in terms of new partnerships, joint ventures, and new market opportunities.

Their network helps attract top talent as well. As private equity grows our franchises, they can assist in recruiting key executives and building strong leadership teams as the franchise owner scales their business.

One story I'd like to share with the Committee – Neighborly has a franchise owner near Atlanta in a growing market. He was ready to retire and, in our world, your three options are to 1) pass along the business to your children 2) close it down or 3) sell the business.

Now, as I'm sure many of you know, many children want to chart their own path and pursue different career opportunities. Only roughly 20 percent of our businesses get passed down. As for the second option, nobody wins when a business closes down, not the franchise owner, nor the community.

That leaves the option of selling. In this case, private equity was able to step in, navigate a sales process that helped our franchise owner exit the business with a tidy profit but then help the purchaser focus on growth. In only two years, the new purchaser doubled the size of the business, fueled by the access to capital provided by their private equity partner.

Now private equity, nor additional working capital, isn't a silver bullet. I tell all my franchise owners that they need a strong foundation and a vision for the future to maximize what private equity can do for their business. But when a franchise owner gets the right thought partner, private

equity can be the rocket fuel that takes their business into the stratosphere. And with that growth comes increased jobs in their communities.

Policies hindering the growth of small business ownership

One headwind is a particular aspect of tax policy – the limitation on the deductibility of interest imposed by the Tax Cuts and Jobs Act. Prior to January 1, 2022, businesses' interest expense deductions were limited by section 163(j) to 30% of their earnings before interest, tax, depreciation, and amortization (EBITDA). Interest deductions are now limited to 30% of earnings before interest and tax (EBIT) – a stricter limitation. This change, combined with rising interest rates, is proving to make incremental investments by small businesses much more expensive.

On average, a business affected by the change could see a three-fold increase in its incremental tax burden, facing both higher interest rates when financing improvements and a very high tax rate.

Additionally, I would like to highlight an issue that has the potential to completely undermine the franchise business model. The National Labor Relations Board (NLRB) issued a final rule on a joint employer standard that would reverse its course back to the harmful 2015 version.

The NLRB's proposal largely reestablishes the broad Obama-era standard of joint employment, under which one company may be deemed the joint employer of a second company's employees not only where it directly or immediately exercises control over the second company's workforce, but where the first company's putative control is indirect, or even simply reserved but not ever actually exercised. This puts franchisors at risk of being sued for things they never did and had no power to stop. Moreover, it risks wiping away the equity that I have spent my life and career building in my businesses and ultimately makes me a middle manager of my brand. The joint employer standard created by the NLRB in 2015 led to a nearly doubling of litigation against franchise businesses, cost franchising $33 billion per year, and preventing the creation of 376,000 new jobs in the four ensuing years. Small businesses will not survive a similar consequence in the current labor market.

The NLRB's changes to the joint employer rule will take away the equity and independence of franchise small business owners and would put their success and livelihoods, including mine, in jeopardy. Franchisors will naturally move to hire numerous attorneys to oversee employment issues and claims across its network of independently owned franchised businesses over which the franchisor has no control. Ultimately, the additional costs to the franchisor would translate into additional costs to independent owners like me, and that would make the franchise business model untenable.

In fact, research released last week by Oxford Economics based on a July 2023 survey of franchisees shows that franchise owners are bracing for more harm from the new NLRB joint employer rule as it injects uncertainty in the franchisor-franchisee relationship and threatens standards enforcement across franchise systems. Overall, 43% of franchisee respondents expected a change in the franchisor/franchisee relationship as a consequence of the NLRB's joint employer rule, although there is uncertainty among franchisees regarding the responses from franchisors. Approximately 20% of respondents expected franchisors to increase control over their operations while another 20% expected franchisors to distance and reduce operations and compliance support.

Approximately 40% of franchisees did not know what to expect, and the remaining 20% expected no change. This uncertainty about franchisor responses to the new joint employer rule brings with

it significant concern among franchisees, with 74% of franchisees expressed a high level of concern at the prospect of increased franchisor control, and 55% a high level of concern with reduced franchisor support.

The Oxford Economics report is also expected to identify increased costs for franchisees as a result of responses by franchisors to mitigate risk under the new joint employer rule. These include the heightened risk of litigation (i.e., 70% of franchisees expected increased litigation) and increases in legal and advisory fees, as well as higher insurance and operations costs. Meanwhile, the new rule may reduce the attractiveness to being a franchisee with respect to operating an independent business and lead to fewer franchises (i.e,, 66% of franchisee respondents expected the new standard to raise barriers to entry into franchising).

This report confirms that franchisees have significant concerns about their ability to do business if the NLRB moves forward with its proposed joint employer rule. A majority of franchisees are highly concerned about both increased franchisor control and decreased franchisor support, demonstrating that franchising currently has the right balance in the franchisor-franchisee relationship. Unnecessary, expanded joint employer liability will hurt franchised businesses – just as it did in 2015.

I urge Congress to reject this unnecessary and over-reaching rule via the Congressional Review Act.

Conclusion

Franchise businesses contribute significantly to our nation's economy, creating a diverse range of employment opportunities from entry-level positions to management roles. By offering these opportunities, franchises help address unemployment and underemployment, ensuring that individuals across our nation have access to stable, fulfilling work.

Moreover, franchised businesses often provide comprehensive education and support for their employees, fostering the development of a skilled workforce. These workforce development programs not only benefit individual businesses but also contribute to the overall strength of our nation's workforce, making it more competitive on the global stage.

Franchise businesses also offer unparalleled opportunities for people of color, women, and veteran entrepreneurs, promoting a more inclusive and diverse business landscape. This diversity strengthens our workforce and helps create a more equitable and prosperous society.

It is also important to acknowledge the role franchise businesses play in community engagement. Most franchises invest in their communities by engaging in charitable activities and supporting local organizations. This not only creates an environment where people can thrive but also contributes to a more robust workforce.

Madam Chair, Ranking Member Mfume, thank you again for holding this hearing and for the invitation to speak on behalf of small business owners everywhere. I look forward to answering any questions you may have.

Testimony of Jeremy C. Kress
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Before the U.S. House of Representatives Committee on Small Business
Subcommittee on Oversight, Investigations, and Regulations
"Navigating Regulations: Alternative Pathways to Investing in Small Businesses"
Tuesday, March 12, 2024

Chairwoman Van Duyne, Ranking Member Mfume, Members of the Subcommittee, thank you for inviting me to testify at today's hearing. By way of background, I am an Assistant Professor of Business Law at the University of Michigan's Stephen M. Ross School of Business and Co-Faculty Director of the University of Michigan's Center on Finance, Law & Policy. My research focuses on bank regulation. Prior to entering academia, I was an attorney at the Federal Reserve Board of Governors where, among other things, I worked on implementing the Dodd-Frank Act and the initial Basel III capital rule.

Small businesses are the lifeblood of the American economy. Indeed, small businesses create more than two-thirds of new jobs in the United States and account for almost half of U.S. GDP.[1] On a personal note, one of the things I love most about my hometown of Ann Arbor is the thriving community of small businesses like Zingerman's Deli and Argus Farm Stop that gives the city its unique college-town feel. In light of the essential role small businesses play in local communities and the national economy, it is critical that policymakers ensure that entrepreneurs have access to funding to establish and grow their companies.

I will make four points in my testimony today. First, regulations enacted after the 2008 financial crisis have helped to promote small business credit availability by enhancing the resilience of the banking system. Second, the Basel III Endgame capital rule proposed last year by the federal banking agencies will further bolster the banking system and will not impair small businesses' access to credit. Third, when small businesses experience difficulty obtaining bank financing, bank consolidation and lax merger oversight are often to blame, as larger and geographically distant banks typically do less small business lending than locally based community banks. Fourth, alternative sources of small business financing such as private equity and private credit may benefit certain small businesses, but they also pose potential risks and must be overseen accordingly. I expand on each of these points below.

I. Post-2008 Bank Regulations Have Promoted Small Business Credit Availability

The actions that Congress and the federal banking agencies took in response to the 2008 financial crisis to strengthen the banking system have helped ensure that small businesses can access credit throughout the economic cycle. The Dodd-Frank Act and Basel III capital rule substantially

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[1] *See* U.S. SMALL BUSINESS ADMINISTRATION OFFICE OF ADVOCACY, 2023 SMALL BUSINESS PROFILE, https://advocacy.sba.gov/wp-content/uploads/2023/11/2023-Small-Business-Economic-Profile-US.pdf (reporting that small businesses contributed a net increase of 4.9 million jobs, or 70 percent of the total net increase in employment between March 2021 and March 2022); *see also* Press Release, U.S. Small Business Administration Office of Advocacy, Small Businesses Generate 44 Percent of U.S. Economic Activity (Jan. 30, 2019), https://advocacy.sba.gov/2019/01/30/small-businesses-generate-44-percent-of-u-s-economic-activity/.

increased banks' equity cushions. Collectively, these reforms have positioned banks to continue lending even under stressful economic conditions. Indeed, a substantial body of economic literature documents that better capitalized banks lend more during economic and financial stress, precisely when small businesses need credit the most.[2]

In fact, bank lending to small businesses has remained strong in the years since Dodd-Frank and Basel III were enacted. According to the Federal Reserve Board, bank loans to partnerships and proprietorships grew at a "robust" pace between 2012 and 2020.[3] Credit conditions for small business lending eased and small business loan spreads declined during the same time frame.[4] This experience confirms that strong capital requirements are consistent with long-term credit creation, economic expansion, and small business growth. Indeed, the period in which policymakers phased in new capital requirements coincided with the longest U.S. expansion on record.[5] The post-2008 financial reforms also prepared banks to support small businesses during the Covid pandemic, with the help of government initiatives like the Paycheck Protection Program (PPP).

Notably, local community banks play a critically important role in financing small businesses. Community banks have an advantage over other lenders when working with small businesses because of their geographic proximity and local knowledge.[6] Thus, community banks lend more than twice as much to small businesses as a share of their total assets compared to larger banks.[7] In addition, community banks approve a higher proportion of small business applicants, and small business owners report higher satisfaction when borrowing from a community bank compared to a larger bank or an online lender.[8] As a result, community banks punch above their weight in small business lending. According to FDIC data, community banks held 36 percent of all U.S. small business loans as of 2019, even though they accounted for just 15 percent of the banking industry's total loans.[9] That gap has likely widened due to community banks' outsized role in delivering PPP

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[2] For example, one study concluded that "a country whose banks enter a crisis with a one percentage point higher capital ratio experiences 0.29 percentage points higher annual loan and 0.18 percentage points higher GDP growth in the following five years, compared to other countries." Basel Comm. on Banking Supervision, *The Costs and Benefits of Bank Capital—A Review of the Literature* 10 (Bank for Int'l Settlements, Working Paper No. 37, June 2019), https://www.bis.org/bcbs/publ/wp37.pdf.

[3] *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., AVAILABILITY OF CREDIT TO SMALL BUSINESSES 11-12 (2022), https://www.federalreserve.gov/publications/files/sbfreport2022.pdf.

[4] *See id.* at 15.

[5] *See* David John Marotta, *Longest Economic Expansion in United States History*, FORBES (Jan. 21, 2020), https://www.forbes.com/sites/davidmarotta/2020/01/21/longest-economic-expansion-in-united-states-history/.

[6] *See* FED. DEPOSIT INS. CORP., COMMUNITY BANKING STUDY, at 1-1 (2012) ("Community banks tend to be relationship lenders, characterized by local ownership, local control, and local decision making.").

[7] *See* AVAILABILITY OF CREDIT TO SMALL BUSINESSES, *supra* note 3, at 37 ("[T]he average banking organization with $1 billion or less in total assets held over 13 percent of its portfolio as small business loans in June 2021. In contrast … the largest organizations—those with assets greater than $10 billion—held approximately 6 percent of their assets as such loans.").

[8] *See* FED. RSRV. BANKS, 2023 REPORT ON EMPLOYER FIRMS: FINDINGS FROM THE 2022 SMALL BUSINESS CREDIT SURVEY 19 (2023), https://www.fedsmallbusiness.org/-/media/project/smallbizcredittenant/fedsmallbusinesssite/fedsmallbusiness/files/2023/2023_sbcs-employer-firms.pdf (reporting that small banks approved 82 percent of small business loan applicants, compared to 71 percent for online lenders and 68 percent for large banks); *see also id.* at 21 (documenting that small businesses that were approved for financing reported an 81 percent satisfaction rate with small bank lenders, compared to 68 percent for large bank lenders and 48 percent for online lenders).

[9] *See* FED. DEPOSIT INS. CORP., COMMUNITY BANKING STUDY, *supra* note 6 at 4-7 (2020).

loans to small businesses during the Covid pandemic.[10] In sum, local community banks are responsible for much of the resilience in small business financing.

II. The Basel III Endgame Rule Will Not Impair Small Businesses' Access to Credit

Contrary to a popular misconception, the pending Basel III Endgame reforms will not threaten small businesses' access to credit. The Basel III Endgame rule, which the federal banking agencies proposed in July 2023, marks the culmination of the United States' implementation of the international framework for strengthening the banking system in response to the 2008 financial crisis.[11] The rule also begins to correct the regulatory weaknesses exposed in 2023 by three of the four largest bank failures in U.S. history. Like the initial Basel III rule that preceded it, the Basel III Endgame proposal will enhance banks' resilience and ensure that they are able to continue lending to small businesses throughout the economic cycle.

In addition to the general principle that bank capital promotes long-term credit availability, there are two specific reasons why Basel III Endgame will not impair banks' small business lending. First, the Basel III Endgame proposal applies to only the 37 largest banking organizations with more than $100 billion in assets.[12] As noted above, these banks focus far less on small business lending than local community banks. The Basel III Endgame proposal does not apply to the nation's 4,600 community and mid-sized banks, many of which specialize in relationship lending. Thus, finalization of the Basel III Endgame rule will not change the capital framework governing the community and mid-sized banks that fuel the small business economy. In fact, Basel III Endgame could help level the competitive playing field for smaller banks by ensuring that the largest banking organizations maintain capital levels commensurate with their risks.

Second, most of the capital increase in the Basel III Endgame proposal is associated with large banks' trading and fee-generating business lines, not their lending activities. In fact, the proposed rule would retain the existing credit risk-weight applicable to large banks' small business loans. Under currently applicable standardized capital rules, large banks apply a 100 percent risk-weight to small business loans, and they would continue to apply a 100 percent risk-weight to small business loans after finalization of the Basel III Endgame proposal.[13] Since the Basel III Endgame proposal would increase large banks' capital requirements for trading and fee-generating businesses, the rule could encourage these banks to place a relatively greater emphasis on small business lending as they optimize their balance sheets to focus on less capital intensive activities. Moreover, large banking organizations are subject to the banking agencies' recently finalized Community Reinvestment Act (CRA) rule, which will incentivize such banks to increase their small business lending in underserved and low- and moderate-income areas.[14]

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[10] *See* Margaret Hanrahan & Angela Hinton, *The Importance of Community Banks in Paycheck Protection Program Lending*, 14 FDIC Q., no. 4, 2020, at 31-36.

[11] Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity, 88 Fed. Reg. 64028 (proposed Sept. 18, 2023) [hereinafter Proposed Rule].

[12] *See id.* at 64168.

[13] *Compare* 12 C.F.R. § 217.32(f)(1) (applying a 100 percent risk weight to corporate exposures under the currently applicable standardized capital rules), *with* Proposed Rule, *supra* note 11, at 64054 (applying a 100 percent risk weight to non-publicly traded corporate exposures under the Basel III Endgame proposal).

[14] *See* Community Reinvestment Act, 89 Fed. Reg. 6574 (Feb. 1, 2024).

III. Bank Consolidation Has Harmed Small Business Credit Availability

Although bank regulation has not impaired small businesses' access to credit, some small businesses still are unable to obtain the financing they need to survive and grow.[15] When creditworthy small businesses have trouble obtaining bank financing, bank consolidation and lax merger oversight are often to blame. Accordingly, policymakers should strengthen guardrails around bank mergers to prevent excessive consolidation and ensure that small businesses can continue to access the credit they need to thrive.

The U.S. banking system has experienced dramatic consolidation over the past century. More than thirty thousand banks operated in the United States during the 1920s. Today, fewer than one in six remain.[16] U.S. financial conglomerates are now bigger than ever, with the six largest bank holding companies (BHCs) controlling more assets than all other BHCs combined.[17] Community banks—which, as noted above, tend to specialize in relationship lending to small businesses—have borne the brunt of this consolidation trend, with more than 7,500 community banks merged out of existence between 1984 and 2011 alone.[18]

Regrettably, small businesses suffer when banks consolidate, as acquired banks reorient their lending toward larger, out-of-market borrowers. Numerous empirical studies have documented a reduction in small business lending associated with bank mergers.[19] As a result, when banks merge, fewer small businesses are formed.[20] For small businesses that are able to obtain loans following a bank merger, credit becomes more expensive, average loan size declines, and nonprice loan terms—such as collateral requirements—become more onerous.[21] Researchers at the Federal Reserve Bank of Philadelphia have documented why small businesses are hurt when community banks disappear via merger: large acquiring banks divert small business lending from their targets'

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[15] According to Federal Reserve data, only 76 percent of small businesses that applied for lines of credit and 66 percent that applied for business loans in 2022 were at least partially approved. *See* 2023 REPORT ON EMPLOYER FIRMS: FINDINGS FROM THE 2022 SMALL BUSINESS CREDIT SURVEY, *supra* note 8, at 17.

[16] There were 4,614 commercial banks and savings institutions in the United States as of the third quarter of 2023. *See Quarterly Banking Profile: Third Quarter 2023*, 17 FDIC Q. 4, 10 (2023).

[17] *See* Jeremy C. Kress, *Reviving Bank Antitrust*, 72 DUKE L.J. 520, 522 (2022).

[18] *See* FED. DEPOSIT INS. CORP., COMMUNITY BANKING STUDY, *supra* note 6 at II.

[19] *See* Steven G. Craig & Pauline Hardee, *The Impact of Bank Consolidation on Small Business Credit Availability*, 31 J. BANKING & FIN. 1237, 1248–58 (2007); Paola Sapienza, *The Effects of Banking Mergers on Loan Contracts*, 68 J. FIN. 329, 354 (2002); Allen N. Berger, Anthony Saunders, Joseph M. Scalise & Gregory F. Udell, *The Effects of Bank Mergers and Acquisitions on Small Business Lending*, 50 J. FIN. ECON. 187, 217, 218 tbl.5 (1998) (finding a reduction in small business lending following mergers between acquirers with more than $1 billion in assets and targets with more than $100 million in assets); Itamar Drechsler, Alexi Savov & Philipp Schnabl, *The Deposits Channel of Monetary Policy*, 132 Q.J. ECON. 1819, 1859 (2017); Katherine Samolyk & Christopher A. Richardson, *Bank Consolidation and Small Business Lending Within Local Markets* 4 (Fed. Deposit Ins. Corp., Working Paper No. 2003-02, 2003), https://www.fdic.gov/bank/analytical/working/wp03-02.pdf.

[20] *See* Bill Francis et al., *Bank Consolidation and New Business Formation*, 32 J. BANKING & FIN. 1598, 1603-09 (2008).

[21] *See* Mark J. Garmaise & Tobias J. Moskowitz, *Bank Mergers and Crime: The Real and Social Effects of Credit Market Competition*, 61 J. FIN. 495, 515 (2006) (concluding that bank mergers between 1995 and 1997 significantly increased the cost of commercial credit and decreased loan size); Sapienza, *supra* note 19, at 354 (finding that acquisitions by large banks increase the cost of credit for small businesses); Jonathan A. Scott & William C. Dunkelberg, *Bank Mergers and Small Firm Financing*, 35 J. MONEY, CREDIT & BANKING 999, 1012 (2003) (documenting more onerous nonprice terms in small business loan contracts following bank mergers).

communities to the acquirers' communities, leaving the targets' communities worse off.[22] Since larger banks tend to favor larger borrowers, bank mergers hasten the consolidation of the national economy and create barriers to entry for new entrepreneurs.[23]

Despite the harmful effects bank mergers have on small businesses, policymakers have done little to stem the tide of bank consolidation. Between 2006 and 2019, the Federal Reserve approved more than 3,500 bank merger applications without denying a single one.[24] The Department of Justice (DOJ) last sued to block an anticompetitive bank merger in the 1980s.[25] Although agency staffers sometimes encourage banks to withdraw problematic merger proposals, acquisitions of community banks are often reviewed under streamlined procedures and receive only cursory evaluation. In particular, the agencies rarely conduct a rigorous evaluation of how a merger would affect the "convenience and needs of the community to be served," including the consequences of the merger for small business credit availability.[26]

Cracking down on excessive bank consolidation is one of the most powerful steps policymakers could take to preserve small businesses' access to credit. In 2021, President Biden's Executive Order on Promoting Competition in the American Economy encouraged the federal banking agencies and the DOJ to "adopt a plan for the revitalization of merger oversight under the Bank Merger Act and Bank Holding Company Act."[27] The agencies' progress to date has been slow, yet there have been encouraging signs. Last year Assistant Attorney General Jonathan Kanter laid out his vision for modernizing bank merger review in light of changes in the banking sector since the DOJ last issued bank merger guidelines in 1995.[28] The federal banking agencies should build on this momentum and update their bank merger policies accordingly. Strengthening bank merger oversight is particularly important considering Capital One's recently announced plan to acquire Discover Financial, which could have significant impacts on small businesses, both as business credit cardholders and as merchants that must pay fees to access credit and debit card payment networks.

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[22] *See* Julapa Jagtiani & Raman Quinn Maingi, *How Important Are Local Community Banks to Small Business Lending? Evidence from Mergers and Acquisitions* 18–20 (Fed. Rsrv. Bank of Phila., Working Paper No. 18-18, 2018), https://www.philadelphiafed.org/-/media/frbp/assets/working-papers/2018/wp18-18.pdf.

[23] *See* Nicola Cetorelli & Philip E. Strahan, *Finance as a Barrier to Entry: Bank Competition and Industry Structure in Local U.S. Markets*, 61 J. FIN. 437, 437 (2006) ("The empirical evidence . . . strongly supports the idea that in markets with concentrated banking, potential entrants face greater difficulty gaining access to credit than in markets in which banking is more competitive."); *id.* at 438 ("[W]e find that more vigorous banking competition . . . is associated both with more firms in operation and with a smaller average firm size.").

[24] *See* Jeremy C. Kress, *Modernizing Bank Merger Review*, 37 YALE J. ON REGUL. 435, 456 (2020).

[25] *See id.* at 453.

[26] Both the Bank Merger Act and Bank Holding Company Act require the responsible federal agency to consider the "convenience and needs of the community to be served" when acting on a merger application. 12 U.S.C. §§ 1828(c)(5), 1842(c)(2).

[27] Exec. Order No. 14,036, 86 Fed. Reg. 36,987, 36,992 (July 14, 2021).

[28] Jonathan Kanter, Assistant Att'y Gen., Dep't of Just., Merger Enforcement Sixty Years After *Philadelphia National Bank* (June 20, 2023), https://www.justice.gov/opa/speech/assistant-attorney-general-jonathan-kanter-delivers-keynote-address-brookings-institution.

IV. Alternative Financing Sources May Benefit Some Small Businesses, But They Also Pose Potential Risks and Should Be Overseen Accordingly

In recent years, some small business owners have turned to alternative sources of financing—such as private equity, private credit, and venture capital—to fund their companies. When structured with appropriate guardrails, these alternative financing arrangements can create new pathways for small businesses to grow. For example, proponents of private credit assert that small businesses may experience quicker underwriting and more flexible covenants when borrowing from a private lender compared to a bank.[29] In addition, some small businesses may benefit from managerial expertise and strategic advice they receive from private equity investors.

However, policymakers and small business owners should approach private capital with caution, for at least two reasons. First, based on the minimal data available, private investors appear to focus on the types of businesses that already have access to capital. Thus, private markets may be ill-suited to reduce barriers to financing for underserved small businesses, including minority- and women-owned companies. Second, because private investors' interests are not necessarily aligned with those of other stakeholders, private capital may pose risks to small business owners, their employees, and their communities. I expand on both of these points below.

A. Private Capital May Not Reduce Barriers to Financing for Underserved Small Businesses

Although private markets are opaque, the little data that are available suggest that private equity, private credit, and venture capital may not be viable options for many small businesses in need of financing. In general, these private investors tend not to make the small-dollar investments that are essential to many proprietorships and partnerships. In addition, private capital flows disproportionately to White, male-owned companies in coastal cities. Thus, rather than reducing inequities in finance, private capital may perpetuate them.

As an initial matter, private market investors generally do not make small-dollar investments on which many small businesses rely. According to Federal Reserve data, small business loans by banks averaged between $71,000 and $167,500 in the third quarter of 2023.[30] By contrast, the average private credit loan exceeded $80 million in 2022.[31] Moreover, private equity made just 14 percent of its investments in companies with fewer than 10 employees in that same year.[32] These data suggest that private capital skews toward larger, established companies, rather than small businesses striving to get off the ground.

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[29] *See* EY, ECONOMIC CONTRIBUTION OF PRIVATE CREDIT TO THE US ECONOMY IN 2022, at ii (2023), https://www.investmentcouncil.org/wp-content/uploads/2023/10/EY-AIC-Private-credit-attributed-employment-report-09-28-2023-1.pdf (reporting the results of a survey commissioned by the American Investment Council).

[30] *See* Fed. Rsrv. Bank of Kan. City, *Small Business Lending Survey, Aggregate Survey Data*, https://www.kansascityfed.org/Research/documents/9943/Q3-2023-Aggregate-Data-PDF-Small-Business-Lending-Survey.pdf (reporting in Table A.3 more than 360,000 outstanding fixed-rate term loans among survey participants totaling $25.8 billion, for an average of approximately $71,000 and in Table A.6 more than 52,000 outstanding variable-rate term loans among survey participants totaling $8.8 billion, for an average of approximately $167,500).

[31] *See* Fang Cai & Sharjil Haque, *Private Credit: Characteristics and Risks*, FEDS NOTES (Feb. 23, 2024), https://www.federalreserve.gov/econres/notes/feds-notes/private-credit-characteristics-and-risks-20240223.html.

[32] *See* EY, ECONOMIC CONTRIBUTION OF THE US PRIVATE EQUITY SECTOR IN 2022, at 9 (2023), https://www.investmentcouncil.org/wp-content/uploads/2023/04/EY-AIC-PE-economic-contribution-report-FINAL-04-20-2023.pdf.

Moreover, private capital may not be readily available to small businesses in underserved areas. One study found that the top ten metropolitan areas—including Silicon Valley, New York, Los Angeles, and Boston—accounted for more than three-quarters of all venture capital investment across the United States.[33] Similarly, businesses in coastal states receive a significant majority of private equity investment.[34] This geographic bias is consistent with the distribution of private investment funds themselves, which tend to be concentrated in coastal areas.[35]

In addition, women and minority entrepreneurs receive very little funding from private investors. For example, female-founded companies accounted for only two percent of all venture capital investment in 2022.[36] Black entrepreneurs similarly receive less than two percent of all venture capital investments each year.[37] Again, these findings track a lack of diversity in private investment firms themselves. As the *Wall Street Journal* reported, firms that are at least 50 percent minority- or women-owned hold just 2 percent of private credit assets, 3 percent of private equity assets, and 6 percent of venture capital assets.[38]

To be sure, these inequities in private capital are directionally consistent with biases documented in the traditional banking sector.[39] However, barriers to financing for underserved businesses may be even more severe in the private market because the CRA's statutory imperative to invest in low- and moderate-income areas does not apply to private credit, private equity, or venture capital.

B. Private Capital May Pose Risks to Small Businesses, Employees, and Communities

Although private capital may benefit certain small businesses, it can also pose potential risks. Since a private fund's primary goal is to maximize returns for its partners, its interests may not necessarily be aligned with those of other stakeholders in a small business. Thus, a private investor may structure its financial commitment in a way, or encourage a management strategy, that is disadvantageous for a small business' owners, its employees, and its community. Accordingly, small business owners and policymakers alike should approach private capital with requisite caution.

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[33] *See* Richard Florida, *A Closer Look at the Geography of Venture Capital in the U.S.*, BLOOMBERG (Feb. 23, 2016), https://www.bloomberg.com/news/articles/2016-02-23/the-geography-of-venture-capital-in-the-u-s.

[34] *See* Joyce Guevarra et al., *Private Equity Most Active in Coastal States Across All US Regions*, S&P GLOBAL MKT. INTEL. (Oct. 16, 2023), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/private-equity-most-active-in-coastal-states-across-all-us-regions-77698269.

[35] *See* Henry Chen, Paul A. Gompers, Anna Kovner & Josh Lerner, *Buy Local? The Geography of Successful and Unsuccessful Venture Capital Expansion* (Nat'l Bureau of Econ. Rsch., Working Paper No. 15102, 2009), https://www.nber.org/system/files/working_papers/w15102/w15102.pdf.

[36] *See US VC Female Founders Dashboard*, PITCHBOOK (Mar. 7, 2024), https://pitchbook.com/news/articles/the-vc-female-founders-dashboard.

[37] *See* Gabrielle Fonrouge, *Venture Capital for Black Entrepreneurs Plummeted 45% in 2022, Data Shows*, CNBC (Feb. 2, 2023), https://www.cnbc.com/2023/02/02/venture-capital-black-founders-plummeted.html.

[38] *See* Maria Armental, *Private Credit's Rising Tide Fails to Lift Women- and Minority-Owned Firms*, WALL ST. J. (Nov. 29, 2023), https://www.wsj.com/articles/private-credits-rising-tide-fails-to-lift-women-and-minority-owned-firms-2b569919.

[39] *See, e.g.*, Maura L. Scott et al., *Revealing and Mitigating Racial Bias and Discrimination in Financial Services*, J. MKTG. RSCH. (forthcoming), https://journals.sagepub.com/doi/full/10.1177/00222437231176470.

While a private investor's incentives may sometimes be aligned with those of its portfolio companies, this is not necessarily the case. Private investors typically have a limited time horizon: the average holding period for a private equity investment and the average maturity of a private credit loan are both about five years.[40] As a result, private investors in small businesses may implement management strategies intended to generate short-term profits, rather than sustainable business growth. For example, private equity investors may liquidate a small business' assets, reduce long-term capital investments, load up the company with excessive debt, or pay out profligate dividends.[41] Similarly, private credit funds may charge inordinately high interest rates or insist on onerous covenants.[42] While these strategies may be detrimental to a small business' long-term prospects, they are often profitable for the private fund that exits the investment after just a few years.[43]

In addition to harming entrepreneurs, private investors' tactics can have adverse effects on small businesses' employees, communities, and other stakeholders. For example, private equity funds frequently terminate employees of portfolio companies in which they invest. One study found that private equity investment in the retail sector led to more than 1.3 million jobs lost in just ten years.[44] Private equity's aggressive cost-cutting strategies can also harm small business customers. At the extreme, private equity ownership has been estimated to be responsible for tens of thousands of deaths in critical industries such as healthcare and nursing homes.[45]

Policymakers could take several steps to mitigate the risks posed by private capital. For example, Congress could enact limits on portfolio companies' dividends to prevent private investment funds from extracting financial resources from the companies in which they invest.[46] Congress could likewise insist that private investment funds assume responsibility for the liabilities of their portfolio companies to better align the funds' incentives with those of the small businesses in which they invest.[47] Finally, policymakers should enhance transparency in private credit so that

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[40] *See* Maria Amental, *Private-Equity Firms Pump Sales Opportunities for 2024*, WALL ST. J. (Feb. 15, 2024), https://www.wsj.com/articles/private-equity-firms-pump-sales-opportunities-for-2024-c0bd7eae (reporting that the average holding period for private equity-backed companies was 5.6 years in 2023); Cai & Haque, *supra* note 31 (reporting that the average maturity in private credit is generally around 5 years).

[41] *See* BRENDAN BALLOU, PLUNDER: PRIVATE EQUITY'S PLAN TO PILLAGE AMERICA (2023).

[42] *See* Cai & Haque, *supra* note 31 (reporting that credit spreads exceeded 650 basis points in 2023, nearly 250 basis points higher than leveraged loans); *see also* M. Shams Billah, *Private Credit Loan Transactions*, PRACTICAL GUIDANCE J. (Aug. 24, 2023), https://www.lexisnexis.com/community/insights/legal/practical-guidance-journal/b/pa/posts/private-credit-loan-transactions ("The extensive set of covenants in private credit loan transactions typically results in lenders having a greater say in the company's affairs…").

[43] *See, e.g.*, Brendan Ballou, *When Private-Equity Firms Bankrupt Their Own Companies*, THE ATLANTIC (May 1, 2023), https://www.theatlantic.com/ideas/archive/2023/05/private-equity-firms-bankruptcies-plunder-book/673896/.

[44] *See* PIRATE EQUITY: HOW WALL STREET FIRMS ARE PILLAGING AMERICAN RETAIL 4 (2019), https://united4respect.org/wp-content/uploads/2019/07/Pirate-Equity-How-Wall-Street-Firms-are-Pillaging-American-Retail-July-2019.pdf.

[45] *See, e.g.*, Atul Gupta et al., *Owner Incentives and Performance in Healthcare: Private Equity Investment in Nursing Homes* (Nat'l Bureau of Econ. Rsch., Working Paper No. 28474, 2021), https://www.nber.org/papers/w28474.

[46] *See* Stop Wall Street Looting Act, H.R. 5648, 117th Cong. (2022).

[47] *See id.*

prudential regulators like the Financial Stability Oversight Council can better monitor the market for emerging systemic risks.[48]

V. Conclusion

In sum, it is vitally important that policymakers ensure entrepreneurs have access to funding to establish and grow their companies. Since the 2008 financial crisis, new guardrails have helped promote small business credit availability by safeguarding the banking system. To foster small business financing in the future, policymakers should slow the rapid pace of bank consolidation to preserve community banks that play an essential role in funding small businesses. Although private capital can fill some gaps in small business financing when local community banks disappear, these alternative financing sources may perpetuate or exacerbate existing disparities and may pose risks to small businesses, their employees, and communities.

[48] *See* FIN. STABILITY OVERSIGHT COUNCIL, ANNUAL REPORT 2023, at 34 (2023), https://home.treasury.gov/system/files/261/FSOC2023AnnualReport.pdf ("The level of opacity in private credit markets can make it challenging for regulators to assess the buildup of risks in the sector.").

Responses of Jeremy C. Kress
Assistant Professor of Business Law
University of Michigan Stephen M. Ross School of Business
Before the U.S. House of Representatives Committee on Small Business
Subcommittee on Oversight, Investigations, and Regulations
"Navigating Regulations: Alternative Pathways to Investing in Small Businesses"
Hearing Date: March 12, 2024
Written Response Date: March 29, 2024

Ranking Member Velázquez

1. Professor Kress, higher capital is essential to making the banking system safer and more efficient. Can you explain how the capital requirements under the Basel III proposal will help promote credit availability to small businesses during times of economic and financial stress?

   Response: Strong capital requirements such as those in the Basel III Endgame proposal help ensure a consistent supply of credit to small businesses throughout the economic cycle. The supply of small business credit tends to be procyclical. During economic downturns, banks typically reduce small business lending to conserve their capital. Better capitalized banks, on the other hand, have a bigger cushion to support small business lending during economic stress. Thus, strong capital requirements are essential to moderating peaks and troughs in small business lending and ensuring a consistent supply of small business credit over time.

2. Professor Kress, much has been made about the potential impact the Basel III proposal will have on banks' lending to small businesses. Can you explain how the proposal keeps many of the same definitions and risk weights for small business loans, and in some places, even decreases the risk weights of small business loans? Do you think this could help promote lending to small businesses?

   Response: As I noted in my written testimony, most of the capital increase in the Basel III Endgame proposal is associated with large banks' trading and fee-generating business lines, not their lending activities. In fact, the proposed rule would not change the existing credit risk-weight applicable to large banks' small business loans. Under currently applicable standardized capital rules, large banks apply a 100 percent risk-weight to small business loans, and they would continue to apply a 100 percent risk-weight to small business loans after finalization of the Basel III Endgame proposal.[1] Moreover, the proposal would *decrease* the risk-weights for some categories of loans, including certain small business credit cards and commercial real estate.[2] Since the Basel III Endgame proposal would increase large banks' capital requirements for trading and fee-generating businesses, these

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[1] *Compare* 12 C.F.R. § 217.32(f)(1) (applying a 100 percent risk weight to corporate exposures under the currently applicable standardized capital rules), *with* Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity, 88 Fed. Reg. 64028, 64054 (proposed Sept. 18, 2023) [hereinafter Proposed Rule] (applying a 100 percent risk weight to non-publicly traded corporate exposures under the Basel III Endgame proposal).

[2] *See* Proposed Rule, *supra* note 1, at 64046, 64051-53, 64169-70.

reforms could collectively encourage large banks to place a relatively greater emphasis on small business lending as they optimize their balance sheets to focus on less capital intensive activities. Indeed, as Bank Policy Institute CEO Greg Baer stated, "Clearly, under the proposal, the best thing you could do is be a bank that all it does is make loans."[3]

3. Professor Kress, some have argued that the Basel III proposal imposes unnecessarily high financing costs on banks' lending to smaller, highly creditworthy businesses, that have not yet gone public. This would result in banks imposing higher interest rates on smaller businesses, many of whom do not list securities on the NYSE or NASDAQ. What is your take? Do you agree with this assessment?

   Response: When establishing risk-weights for corporate exposures, the banking agencies balance the dual objectives of (1) promoting small business credit availability, and (2) ensuring that banks maintain sufficient capital to withstand potential losses on such exposures. Notably, section 939A of the Dodd-Frank Act prohibited the banking agencies from relying on external credit ratings to calibrate risk-weights for corporate exposures, as is done under the international Basel III accord and in many international jurisdictions.[4] In the absence of authority to establish risk-weights based on external credit ratings, the federal banking agencies concluded in the proposed rule that non-publicly traded corporate exposures "pose greater risks than those of publicly-traded corporate exposures that are deemed investment grade."[5] To the extent that loss history indicates that non-publicly traded corporate exposures are more prone to default than publicly traded corporate exposures, a higher risk-weight for non-publicly traded corporate exposures could help ensure that banks maintain sufficient capital to withstand losses. As alluded to above in response to Question #1, setting capital requirements in this way is intended not to penalize non-publicly traded companies, but rather to ensure that banks maintain a strong enough capital cushion to support lending to all creditworthy small businesses, even during challenging economic times.

4. Professor Kress, isn't it true that when banks lend to small businesses those loans are funded through a combination of customer deposits and capital—and that capital is constantly used to support lending? Therefore, isn't it usually true that weaker capitalized banks are the first ones to curtail lending to smaller businesses during times of economic stress?

   Response: Correct. Contrary to a common misconception, bank capital is not money that is "set aside" or locked away in a vault. Bank capital requirements simply establish the minimum extent to which a bank must fund itself through equity rather than through debt. Far from being unavailable for the bank to use, bank capital is never idle. It is a source of funds that banks routinely deploy for lending, trading, and other activities.

   It is true that during economic stress weaker capitalized banks typically curtail lending to a greater extent than stronger capitalized banks. As one study of the 2008 financial crisis by

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[3] *Capital Wrap: A Roundup From Capitol Account's Basel Endgame Event*, CAPITOL ACCOUNT (Oct. 27, 2023), https://www.capitolaccountdc.com/p/capital-wrap-a-roundup-from-capitol.
[4] *See* 15 U.S.C. § 78o-7 note.
[5] Proposed Rule, *supra* note 1, at 64054.

International Monetary Fund economists concluded, "Banks that held more tangible common equity, either in absolute terms or in excess of the regulatory standard, reduced lending less than other banks with similar exposure to shocks."[6]

5. Professor Kress, the Basel III proposal only applies to the 37 largest banks in the country—those over $100 billion in assets. It does not impact community banks, which do approximately 40 percent of the nation's small business lending. Therefore, wouldn't you agree that the banks that do the best job of providing credit to small businesses are not the banks that will be affected by the proposal?

Response: I agree that the banking organizations affected by the Basel III Endgame proposal—the 37 largest banking organizations with more than $100 billion in assets—focus far less on small business lending than local community banks. The Basel III Endgame proposal does not apply to the nation's 4,600 community and mid-sized banks, many of which specialize in relationship lending to small businesses. As I noted in my written testimony, community banks lend more than twice as much to small businesses as a share of their total assets compared to larger banks.[7] In addition, community banks approve a higher proportion of small business applicants, and small business owners report higher satisfaction when borrowing from a community bank compared to a larger bank or an online lender.[8] As a result, community banks punch above their weight in small business lending. According to FDIC data, community banks held 36 percent of all U.S. small business loans as of 2019, even though they accounted for just 15 percent of the banking industry's total loans.[9]

Finalization of the Basel III Endgame rule will not change the capital framework governing the community and mid-sized banks that fuel the small business economy. In fact, Basel III Endgame could help level the competitive playing field for smaller banks by ensuring that the largest banking organizations maintain capital levels commensurate with their risks.

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[6] Tumer Kapan & Camelia Minoiu, *Balance Sheet Strength and Bank Lending: Evidence From the Global Financial Crisis*, 92 J. BANKING & FIN. 35, 35 (2018).

[7] *See* AVAILABILITY OF CREDIT TO SMALL BUSINESSES, *supra* note **Error! Bookmark not defined.**, at 37 ("[T]he average banking organization with $1 billion or less in total assets held over 13 percent of its portfolio as small business loans in June 2021. In contrast … the largest organizations—those with assets greater than $10 billion—held approximately 6 percent of their assets as such loans.").

[8] *See* FED. RSRV. BANKS, 2023 REPORT ON EMPLOYER FIRMS: FINDINGS FROM THE 2022 SMALL BUSINESS CREDIT SURVEY 19 (2023), https://www.fedsmallbusiness.org/-/media/project/smallbizcredittenant/fedsmallbusinesssite/fedsmallbusiness/files/2023/2023_sbcs-employer-firms.pdf (reporting that small banks approved 82 percent of small business loan applicants, compared to 71 percent for online lenders and 68 percent for large banks); *see also id.* at 21 (documenting that small businesses that were approved for financing reported an 81 percent satisfaction rate with small bank lenders, compared to 68 percent for large bank lenders and 48 percent for online lenders).

[9] *See* FED. DEPOSIT INS. CORP., COMMUNITY BANKING STUDY, at 4-7 (2012).

Engine

Engine Statement for the Record regarding the House Small Business Committee's Subcommittee on Oversight, Investigations, and Regulations hearing: *Navigating Regulations: Alternative Pathways to Investing in Small Businesses*

March 22, 2024

The Honorable Beth Van Duyne
Chairwoman, Subcommittee on Oversight, Investigations, and Regulations
House Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515

The Honorable Kweisi Mfume
Ranking Member, Subcommittee on Oversight, Investigations, and Regulations
House Committee on Small Business
2069 Rayburn House Office Building
Washington, DC 20515

Dear Chairwoman Van Duyne, Ranking Member Mfume, and Members of the House Small Business Committee's Subcommittee on Oversight, Investigations, and Regulations,

Thank you for holding a recent hearing, *Navigating Regulations: Alternative Pathways to Investing in Small Businesses.* As a nonprofit research and advocacy organization that supports high growth startups—our economy's principal job creators—Engine strongly supports efforts to ensure our nation's entrepreneurs can access the capital they need to launch and grow startups.

While we are broadly supportive of steps to improve capital access across all major funding streams—from venture capital, to federal grants and loans, to increasing generational wealth—so that all founders are well supported in our startup ecosystem, this is particularly important for underrepresented founders, who face significant challenges in accessing the funding and resources they need.

For the past 18 months, with the support of the Ewing Marion Kauffman Foundation, Engine has been engaged in a project entitled Innovation for All, to identify barriers faced by underrepresented founders and propose policy solutions to bring about more equity in the startup ecosystem.[1] While this project is not yet completed, we have engaged with dozens of underrepresented founders, including through a series of roundtable discussions. Attached, you will find a recent blog post[2] we published detailing what we have heard through our discussions with founders thus far. The entrepreneurs highlight a number of areas where they face challenges, in particular with respect to capital access. We hope you will look to this information as you continue your work in examining alternative pathways to investing in small businesses

[1] www.engine.is/innovationforall
[2] Jennifer Weinhart, What the ecosystem needs to ensure Innovation for All (Mar. 22, 2024), https://engineadvocacyfoundation.medium.com/what-the-ecosystem-needs-to-ensure-innovation-for-all-ea2e64b142dc

and while thinking about the scope of the capital formation issues many underrepresented founders encounter.

Thank you again for holding this important hearing. As always, Engine remains committed to advancing the interests of U.S. startups, and is available for any follow up questions.

Sincerely,

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What the ecosystem needs to ensure Innovation for All

By Jennifer Weinhart, Senior Policy Advisor, Engine

The U.S. startup ecosystem is built on the foundation that entrepreneurship is for anybody with an idea—but in practice, systemic inequities and socio-economic factors hold back many founders and would-be founders. In September of 2022, with the help of the Ewing Marion Kauffman Foundation, Engine embarked on a two-year project in support of a more equitable startup ecosystem—one in which founders and investors from all backgrounds have the opportunity to innovate and access the capital and resources they need.

For the past 18 months, we have talked to dozens of founders representing different, and often intersectional backgrounds—founders of color, Black founders, women founders, rural founders, immigrant founders, and LGBTQ+ founders. We've held six roundtables, undertaken a vast network survey, facilitated engagement with policymakers, submitted agency comments and statements for the record to Congress, advocated for several pieces of legislation through committee and House votes, and placed op-eds.

And our work is not done. Through these, and ongoing efforts, we continue to identify barriers faced by underrepresented founders—from diminished access to capital, networks, and opportunities to serve as an investor, to struggles accessing and affording child care, health care, and student loan relief, to difficulties navigating the visa process and hiring needed talent, and more—and propose policy solutions to bring about more equity in the innovation ecosystem.

Here's a look at what we've heard so far:

Access to Capital

Access to capital is perhaps the biggest challenge founders face regardless of background. Diverse founders and investors alike are held back by the limitations of the current accredited investor definition, which equate independent and generational wealth—which many underrepresented founders and would-be investors do not have—with financial acumen. Andrew Prystai, founder of Omaha, NE-based startup Event Vesta, told us, "it just doesn't make sense that someone in Carroll, Iowa or Omaha, Nebraska, that's making $200,000 a year doesn't qualify as an accredited investor. But I guarantee that they probably have more free cash flow than someone making 250k in New York or San Francisco." And Tani Chambers, founder of New York, NY-based RAVN, conveyed that her startup has a "community of over 30,000 Black women who are established and aspiring investors. . .sometimes it's not about the percentage of your income, but that you may have a windfall, you have some disposable income in excess and you want to invest and grow, and according to what's being put out there by the SEC, it would limit them."

But it's not just the accredited investor definition that is hurting diverse founders. Underrepresented founders have diminished access to all capital streams, from personal savings, to friends and family funding, bank loans, venture capital, federal grants, and more. Federal grants are particularly challenging for many founders, because, "[t]here's never any mechanism for feedback. I asked for feedback, and they send you what's basically a form letter." Kathryn Rose, founder of Framingham, MA-based startup, getWise goes on to explain, "If they want folks in underserved areas to apply for these grants, they have to give us not only clear guidelines, but also give us feedback on how we can make it through the application process." And for others, navigating the Small Business Administration is a challenge—Regina Gwynn, founder of New York, NY-based startup, Black Women Talk Tech told us, "[t]here's a lot of things at the SBA that could be tweaked--there should literally be an ombudsman that is dedicated to black and brown founders in each state, to make sure that every single registered startup in their state has all the materials that they need."

For many founders, bootstrapping is a struggle, and can even limit access to further forms of financing. Jessica Thurmond, has experienced this first hand with her Nashville, TN-based company, Athelo Health—she explains, "I don't have a lot of friends and family who have a cool million bucks laying around that they can just toss me whenever they feel like it. We bootstrapped predominantly. But what's so interesting about that is in the space of venture capital, [bootstrapping] is like a negative...VCs don't think you're hot because you haven't gotten a bunch of VC money previously."

Access to Networks

Roundtable participants also expressed difficulty cultivating a network and mentors to help guide them through the process of launching and growing a company, sourcing investors, and building a customer base. Seasoned founder, Sarah Adler, of Palo-Alto, CA-based startup Wave, explained of her fundraising journey, "[without] a small supportive network of other female founders who have already been through the process, I would have spent six months fundraising talking to 500 people instead of 30." And Nitin Pachisia, co-founder of San Francisco based-venture capital fund Unshackled Ventures, also underscored the importance of building a network for immigrant founders, "[t]he network and the community is truly instrumental in a lot of us moving faster, not just from an immigration standpoint, but also the shared journeys of being an immigrant."

Access to Talent

Other founders shared their struggles accessing the talent they need to grow their companies. "Finding great talent is a challenge," Tiffany Stanard, founder of Philadelphia, PA-based startup Stimulus, told us."[D]epending on what it is you're building and selling, you need people with more experience to build your product and to grow your team. And trying to get that talent, whether you're directly promoting within or you are trying to poach them from another company...is a challenge, getting someone to come to a startup from a large company." Other founders, like Amélie-Sophie Vavrovsky, founder of Stanford, CA-based startup Formally,

explained that policymakers should enable foreign students in U.S. universities to more easily stay in the U.S.— "how do we help the students that we trained here that we educated here, that have already brought a lot of value economically and also socially to the country–how do we help those folks thrive?"

For immigrant founders, navigating the visa process is often exceedingly difficult. Susanna Sierra, founder of Miami, FL-based startup BH Compliance, told us she was "more worried about the visa application than my sales meeting with new potential clients." Multiple founders underscored that the O-1 visa process was long and challenging—"It's really hard to know, am I 'extraordinary'? Do I qualify? What does extraordinary ability even mean? How do we break that down into tangible criteria. . .to consider yourself extraordinary, you have to have already experienced some sort of traction, you have to already experienced some sort of belief in yourself that you could even be considered extraordinary under the US government regulation." Others insisted that government should focus energy on improving existing pathways— "there's some real opportunity in pathways that exist, but making them more applicable does not require congressional approval, that is very much in the hands of existing machinery."

Access to child care

For women founders in particular, child care struggles are a significant hindrance to becoming an entrepreneur and finding success. Many of these women founders expressed the limitations of existing programs and support in the child care space in a letter to Congress, calling for an expanded child tax credit. They explain, "[p]olicymakers should be doing everything in their power to dismantle barriers to entrepreneurship, including those created because women more often than not shoulder the responsibility of family caregiving." And Engine Executive Director Kate Tummarello and Liz Tenety, co-founder of Motherly, agreed in a joint op-ed. They call on Congress to "invest in supporting women entrepreneurs, including those with children. [Because] Motherhood is a powerful catalyst for entrepreneurship; mothers see problems others cannot and often from different perspectives."

Access to exits

Successful exits drive the dynamic flows of knowledge, talent, and capital that build and grow successful startups ecosystems, making them a critical part for broadening where and by who startups are founded. Rural founders often lack the institutions that are critical to making successful exits happen. Meanwhile, other underrepresented founders historically shut out of institutions and networks critical to mergers and acquisitions or going public also encounter higher barriers to experiencing a successful exit. Preston James II of Austin, Texas-based startup DivInc, urged policymakers to expand access and encourage M&A because "with the capital from selling their company, as an example, a Black founder can become an investor that then invests in more Black founders. They can share their expertise to help those founders build to their own exit and the cycle repeats. Over time, this ripple effect builds generational wealth and fosters an ecosystem that helps diverse communities to prosper."

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This is just a brief snapshot of what we've heard throughout the past 18 months. One thing is clear—the diversity of the U.S. startup ecosystem is its greatest strength—but there is work to be done so that there is also equity. There's more to come, both through the Innovation For All project, and beyond.

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