

# SEC Staff Examines Impact of Regulation on Capital Formation and Market Liquidity

August 15, 2017 | Client Update | 5-minute read

In response to a statutory requirement, the SEC Staff of the Division of Economic and Risk Analysis (DERA) has [issued a lengthy report](#) to Congress on the combined impacts of the Dodd-Frank Act and other financial regulations on access to capital for consumers, investors and businesses and market liquidity. DERA studied (a) capital raising in the primary markets by analyzing evidence on the evolution of the issuance of debt, equity and asset-backed securities across registered and exempt offerings and (b) secondary market liquidity by analyzing market activity and liquidity in corporate bonds and US treasuries, along with funds and investment companies that invest in those securities.

DERA considered whether regulatory reform efforts, including the Volcker Rule and the JOBS Act mandates adopted by the SEC, impacted any of those capital market activities. The report, and its conclusion, is particularly interesting in light of increased discussions around whether regulations have adversely affected capital formation, and what should be done in response.

Several challenges impede DERA's attempts to quantify the effects of regulatory reform. Overlapping implementation makes it difficult to isolate the effect of any single requirement, especially when market participants change their behavior in anticipation of new rules during a rulemaking notice and comment period, so that no clear baseline exists to measure the potential economic impact. DERA also speculates that many of the changes made by market participants would have occurred even without the reforms, in light of the perceived shortcomings in business models reflected during the financial crisis. Post reform macroeconomic conditions, including the economic recovery and low interest rate environment, also make it tough to isolate and quantify the benchmark levels of primary issuance and market liquidity if the regulations had not been adopted.

DERA did not find that total primary market security issuance has lowered since the enactment of Dodd-Frank, and in fact may have increased around the implementation of the JOBS Act. Total capital formation from 2010 (when Dodd-Frank was signed into law) through the end of 2016 is approximately \$20.20 trillion, of which \$8.8 trillion was raised through registered offerings, and \$11.38 trillion through unregistered offerings. The evidence of the impact of regulatory reforms is more mixed for market liquidity, with different measures showing different trends. However, many of the changes are consistent with a combination of several factors and not simply the result of new rules and regulations, including the electrification of markets, changes in macroeconomic conditions, and post-crisis changes in dealer risk preferences that pre-date Dodd-Frank.

Most of the 300+ page DERA report focuses on secondary market liquidity, but we focus only on DERA's insights into the initial access to capital in this post. The report acknowledges that issuers will choose the optimal type of offering based not just on the current regulatory environment but also factors such as the general state of the economy and interest rate cycles. Total registered issuance has increased steadily from 2011 through 2016, and grew from \$1.42 trillion in 2015 to \$1.49 trillion in 2016. The period of 2013-2016 witnessed the largest amount of registered issuances in the United States for the last 11 years.

As for IPOs, a frequent topic discussed under the new SEC leadership, the report shows that capital raised through IPOs ebbs and flows over time, reaching highs in 1999, 2007 and 2014, and lows in 2003, 2008, and 2016. DERA states that it is difficult to disentangle the many contributing factors that influence IPO dynamics. Ultimately the Staff decides that it cannot determine whether the Dodd-Frank Act affected IPO activity, since they are unable to identify any particular mechanism through which the Dodd-Frank Act would have impacted IPOs. For example, the executive compensation provisions of the Act have not been implemented, and other provisions of the Act did not apply to EGCs.

While the JOBS Act (passed in 2012) may account for the increase in the number of small company IPOs, as IPOs with proceeds up to \$30 million accounted for approximately 17% of the total number of IPOs in the period 2007-2011 and 22% in the period 2012-2016, DERA determined that it is difficult to distinguish the effects of the JOBS Act from the improvement in macroeconomic activity overall. The average and median offering sizes for IPOs are close to what they were prior to the crisis, although there is some increase in smaller company IPOs. In addition, DERA believes when IPO activity declines, as it did during 2015 to 2016, it is more consistent with changes in investor demand, market saturation and the increased availability of private funding and other alternative exit strategies.

The report addresses the rise in unregistered offerings. Unregistered issuances during 2009 to 2016 have consistently surpassed registered offerings, by 22% from 2009 through 2011 and 26% from 2012 through 2016, which may be underestimated since some exempt offering information is not available.

DERA examined offerings under Rule 506(c) of Regulation D, promulgated under the JOBS Act, as to whether regulation could actually spur capital formation. Issuances claiming this new exemption accounted for 3% of the reported capital raised from 2013, when the rule became effective, through 2016. But the vast majority of Regulation D issuers continue to raise capital through Rule 506(b) offerings. There have been many reasons cited for why the new rule hasn't been wholly embraced, including uncertainty surrounding the regulation as to what activities constitute general solicitation, the possibility of added burdens in verifying accredited investor status, and the ready availability of Rule 506(b) for issuers who want to use Regulation D and do not need any additional flexibility. It is also unclear whether the Rule 506(c) activity merely reallocates from other forms of offerings rather than represent new transactions.

Overall, the DERA report, while full of data and cites to many studies and resources, at best is inconclusive on whether regulations have hampered the capital markets. Instead, it rather suggests that of all of the factors that may play a role, at least with the current data available, regulation likely has minimal impact.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

**Ning Chiu**

+1 212 450 4908

[ning.chiu@davispolk.com](mailto:ning.chiu@davispolk.com)

---

*This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's privacy notice for further details.*