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EXAMINING THE IPO PROCESS: IS IT WORKING FOR ORDINARY INVESTORS?

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITIES, INSURANCE, AND INVESTMENT

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

ON

EXAMINING THE IPO PROCESS

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C O N T E N T S

WEDNESDAY, JUNE 20, 2012

EXAMINING THE IPO PROCESS: IS IT WORKING FOR ORDINARY INVESTORS?

WEDNESDAY, JUNE 20, 2012

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 9:34 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Jack Reed, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN JACK REED

Chairman REED. Let me call the hearing to order. My Ranking Member, Senator Crapo, is delayed. We anticipate that other colleagues will be arriving shortly, but since the panel is assembled and the time has come, it is appropriate to begin the hearing.

Let me welcome everyone to the hearing. It is a very important topic, "Examining the IPO Process: Is It Working for Ordinary Investors?"

I have had the opportunity to read your testimony, and let me thank you all for very thoughtful and insightful comments. I appreciate it, and I look forward to the questioning.

The number of individuals participating in our capital markets has grown substantially, especially for investors trying to save for retirement through their 401(k) plans and other retirement plans. Once an opportunity that was limited primarily to institutional investors, now the chance to participate in initial public offerings is increasingly available to ordinary investors.

A central question I want this hearing to answer is: Is the system fair and transparent, and is it working for everyone, particularly individual investors? A dysfunctional IPO market can harm our economy. While the summer is typically the peak season for IPOs, in the wake of Facebook's highly publicized IPO troubles, which was marred by technical mishaps, many planned IPOs have been postponed or canceled, and more Americans and the investment community are questioning the integrity of the IPO process. And, frankly, I think we all recognize that without confidence by investors, the ability to efficiently form capital and to generate jobs is impaired. That confidence is fundamental to our free market system.

Regulators continue their investigation into some of the specific problems surrounding the Facebook IPO. This hearing is a chance to broadly and publicly examine the procedures for taking a company public. That is one data point. But it is a much, much broader set of issues that we want to confront this morning.

There is also concern that the JOBS Act recently passed made some of the biggest regulatory changes to U.S. capital markets in decades and weakened some key investor protections. It may have caused some other new problems, such as allowing more shell companies for reverse mergers to go public in the United States. Indeed, a recent *Wall Street Journal* article quoted special purpose acquisition companies and blank-check companies—basically empty shells with almost no employees that are used in mergers or as a back-door route to U.S. stock listings—have been quick to identify themselves in regulatory filings as "emerging growth companies." The new law uses that label to describe which companies, once they have applied to go public, should be exempt from some financial reporting and corporate governance rules.

Companies with less than $1 billion in annual growth revenues are eligible for the less restrictive rules—a standard that would have been met by a majority of companies conducting an IPO in the last several years. So this is a very high threshold, obviously. Companies that qualify as emerging growth companies do not have to comply with the Sarbanes-Oxley Act's requirements that auditors review their internal controls. It also allows them to make fewer financial disclosures, use a new confidential SEC review process for IPOs, and lets their bankers communicate more freely with selective investors, the more sophisticated players and investment banks.

Underwriting the IPOs of emerging growth companies is a big business on Wall Street. Investment banks are expected to take full advantage of the new, less stringent requirements. As a result, retail investors may be denied critical information that is essential to making sound investment decisions.

Unfortunately, during the expedited process used to pass the JOBS Act, improving the efficiency and transparency of the existing IPO system was not really discussed. With full and fair information from investors, our capital markets are more efficient and transparent and can better facilitate the capital formation so important to our Nation's economy.

Clearly, all investors face certain risks when contributing capital to either small or large companies. In fact, the panelists made the case quite clearly that risk is inherent in all of these IPOs, and that should be acknowledged. However, we need to ensure that there is not one set of rules for sophisticated clients and another set for ordinary investors. Everyone should have access to the same set of data and disclosures, or at least equivalent data and disclosures.

Chairman Johnson has instructed Committee staff to conduct its due diligence regarding issues raised in the news about Facebook's IPO. This hearing will be part of that, but, again, the focus is on the broader issue of IPOs. And many have stated that once these briefings have concluded, we will determine if a full Committee hearing is necessary.

So today's hearing will serve as a jumping-off point, broadly examining the procedures for taking a company public, and I think it will be a very productive hearing.

When Senator Crapo arrives, if he is able to arrive, or my colleagues, if they wish to make an opening statement, I will interrupt your statements and give them that opportunity. But let me now proceed to introduce the witnesses and ask for your statements.

Our first witness is Dr. Ann Sherman. Dr. Sherman is associate professor of finance at DePaul University. She received her Ph.D. in economics from the University of Minnesota. Dr. Sherman's research on IPO methods has been published in top finance journals, and she was a consultant on the Google IPO. Dr. Sherman has taught finance at the University of Wisconsin, Madison, the University of Notre Dame, and Hong Kong University of Science and Technology.

Our next witness is Ms. Lise Buyer. Ms. Buyer is the founder and principal of the Class V Group, an organization providing strategic and logistical guidance to companies contemplating an initial public offering. Ms. Buyer has firsthand experience as an institutional investor, investment banker, venture capitalist, board member, and internal IPO coordinator analyst and employee. Previously, Ms. Buyer was the director of business optimization for Google, Inc., where she was one of the chief architects of the company's innovative IPO.

Our next witness is Mr. Joel H. Trotter. Mr. Trotter is a partner at Latham & Watkins and is the global cochair of the firm's public company representation practice group and the deputy chair of the corporate department in the Washington, DC, office. Mr. Trotter's practice focuses on capital markets transactions, mergers and acquisitions, securities regulation, and general corporate matters. Thank you, Mr. Trotter.

And, finally, our last witness is Mr. Ilan Moscovitz. He is a senior analyst for The Motley Fool, a global financial service company and tireless advocate for individual investors, specializing in financial reform, macroeconomics, and shareholder rights. Mr. Moscovitz's research has been cited numerous times in the national press.

We thank you all for being here. All of your testimony will be made part of the record in its entirety, and I would ask you to summarize it within 5 minutes. We will begin with Dr. Sherman.

STATEMENT OF ANN E. SHERMAN, ASSOCIATE PROFESSOR OF FINANCE, DEPAUL UNIVERSITY

Ms. SHERMAN. Chairman Reed, thank you for inviting me to testify today. My research has been primarily on IPO methods in various countries, and in the last three decades, there has been a lot of experimentation in various countries with different methods.

Now, one of the main points I want to make today is that the U.S. method, commonly called "book building," is the most popular method around the planet. And it was not always that way. If you go back to the early 1990s, it was used really only in the U.S. and sometimes Canada. By the end of the 1990s, it was the dominant method, and it has become even more popular since then.

Now, the difference between book building and the other methods is that with book building, the underwriter gets feedback from investors before setting the offer price. And it is not always easy to get people to honestly tell you that they like an offering if they know that you are going to use that information to raise the price. And that is why it is important that the underwriter also controls allocations, who gets what. So by controlling allocations, the underwriter can favor regular investors that do not just try to cherrypick the hot offerings, can favor investors that give feedback that help to set the price, and can favor long-term investors. So there are reasons why the underwriter may favor institutional investors. Ordinary investors may not have the expertise or resources to play the same role in an IPO.

Now, that does not mean that they cannot participate. If you look around the world, most countries open up the IPO process to all ordinary investors, but the key is that they open up the allocations, but they do not control the price setting. Ordinary investors do not help to set the price for IPOs. They just get a chance to get shares.

So the most popular method outside the U.S. is a hybrid or a combination where they have a tranche that uses book building and they use that to set the price and allocate to institutional investors; and then for ordinary investors, they have a separate tranche. Ahead of time it is announced what proportion of shares will go into each tranche, and everyone is allowed to order shares in the retail tranche. And if it is oversubscribed, they have basically a lottery. So it is open, it is transparent, everyone has a chance to get shares; but they do not disrupt the price-setting process. That is a method that has worked well around the world.

The method that has not worked well around the world is to use an auction that is open to everyone so that everyone has an equal say in setting the price. I do not want to use up too much of my introductory time, but I would be happy to answer questions on that. The auction method has been used in more than two dozen countries, and they have pretty much all abandoned it because of huge problems.

When I was doing literature searches or newspaper searches to find out more about various IPO auctions, I learned that good search terms were “flop,” “disaster,” “debacle,” “catastrophe,” “calamity.” The auction method is one that has blown up in people’s faces around the world, which is why countries stopped using it. Retail investors should be allowed to participate, but you have to be very careful about giving them a major role in the price-setting process.

So what should the U.S. do? Frankly, I am neutral on whether the U.S. should require issuers to give a bigger role to ordinary investors. But I feel strongly that if we are going to do that, it should be through the hybrid method with a separate tranche so that everyone has an equal chance of getting shares, but it does not disrupt the price setting.

Last, on the role that small investors should play in private equity—and in particular crowdfunding, where you have maybe a Web site and a bunch of people put up a few hundred dollars each—I see two big problems with that.

The first is: Who is going to do the due diligence? Fraud is a major problem with these. Someone needs to screen these offerings before they get funding, and someone needs to continue to monitor them. And if we do not find a way to do that, crowdfunding could be a disaster for ordinary investors.

And the second question is: Who is going to set the price? I hope that I have communicated that letting ordinary investors price IPOs has been disastrous, and if they are not good at pricing relatively sophisticated or advanced IPOs, then there is even less reason to think that they can price early stage startups.

Again, thank you, and I would be happy to answer any questions.

Chairman REED. Thank you very much, Dr. Sherman.

Ms. Buyer, please.

STATEMENT OF LISE BUYER, FOUNDER AND PRINCIPAL, CLASS V GROUP, LLC

Ms. BUYER. Chairman Reed, thank you very much for inviting me to be here today. I am honored to be able to submit my commentary to such an important discussion of the IPO process, which is clearly such an important rite of passage for so many companies. Having been an institutional investor responsible for deploying the assets of aggregate individuals; an investment banker, part of the team that designed and implemented a unique and high-profile, IPO; and a board member of a company as it transitioned from private to public, and then afterwards; I have looked at the IPO process from a variety of perspectives, and it is from that combination of perspectives that I offer my comments today.

IPOs, as you mentioned, are always and inherently very risky—riskier than investing in seasoned companies. In fact, if we look at the class of 2012, as of a day ago the best-performing IPO year to date is a Buffalo, New York-based company, Synacor, which had a very difficult time getting public, traded up 5 percent day one, and now is up an incremental 162 percent.

Then there is Ceres, which was warmly embraced by the market in its IPO in February, up 14 percent day one, currently down 31 percent.

And then there is the higher-profile Splunk, which was up 109 percent on the day of its IPO, today is up 90 percent, meaning that those people who participated in the frenzy of day one may be underwater even though the stock has nearly doubled from its initial public offering.

The point of that is to say it is very difficult to predict what any stock will do on its IPO or shortly after. And, in fact, there is no right answer. There are always winners and losers.

I believe that—in fact, the people who invest just day one are really speculators, not investors. Investors need to be in for a longer period of time.

I believe the importance here is for overseers to make sure that up front anyone who chooses to participate in an IPO fully consider not only the possible rewards but also the very, very real risks. And, in fact, if I may make only one suggestion here today, I would suggest that before confirming an order, be it by phone or in person or online, every individual be asked to read, or be read to, acknowledge, and confirm agreement with a very short, simple, bold statement along these lines: "I fully acknowledge that this stock has an equal chance of trading up or trading down from my purchase price. Furthermore, I acknowledge that shares of newly public companies routinely trade below the prices at which they are initially offered."

My hope is that a cigarette-box type warning of this nature could just add a moment of pause to transaction decisions that are too often based on emotion and not on thoughtful analysis.

With my remaining time, I would add two other comments.

First, as we know, some institutions have the chance to meet with management teams to see a presentation and ask questions during a roadshow. Clearly, it is not possible for individuals to have that same exposure, although with the advent of the retail roadshow, they now have the chance to watch the presentation, even though I suspect that most of them do not. I wonder if there is a chance to level the playing field by suggesting to companies going public that they add an hour or they offer an hour of Q&A, online Q&A, for individual investors, during which time they could respond to presubmitted questions from any investor who had actually watched the retail roadshow. Just a chance to level the playing field by allowing small investors to have reasonable questions answered.

And, finally, a third comment I would make echoes what you just said. I have significant concerns about many of the provisions of the well-intentioned, recently passed JOBS Act as these provisions reduce transparency and really roll back important, in my opinion, investor protections. I would suggest that that Act may need some refinement.

To the question in our initial invitation which Dr. Sherman just addressed, pricing and allocation, based on my years of watching IPOs, I would suggest that those final decisions need to be completely in the hands of professionals who have a fiduciary obligation for those whose money they are overseeing, the management of the company selling stock, and the investment bankers who have the best aggregated information about the market and about interest in the particular security. I do not think it is appropriate for retail investors to be able to set the price in IPOs.

So, in summary, I think generally the process works very well both for companies and for informed—and I would underline "informed"—investors. I would recommend, one, that we add a request for a signed, straightforward acknowledgment of risk; two, perhaps management teams for a Q&A session for individual investors; and, three, that we revisit the provisions of the JOBS Act.

Thank you very much.

Chairman REED. Thank you very much, Ms. Buyer.

Mr. Trotter, please.

STATEMENT OF JOEL H. TROTTER, PARTNER, LATHAM & WATKINS LLP

Mr. TROTTER. Thank you, Mr. Chairman, and my thanks also to Ranking Member Crapo and the other Members of the Subcommittee and their staffs. I have provided you all with detailed information in my written testimony and want to highlight four key areas that bear emphasis: first, the national importance of our IPO markets; second, a bedrock principle of our system of Federal securities regulation, which is disclosure not merit regulation; third, another bedrock principle, which is the concept of materiality in that disclosure; and, finally, I want to comment on the nature of risk, reward, and capital formation.

The first point I would like to make is that IPOs must compete with other forms of capital formation. Emerging growth companies have two alternative paths for providing liquidity into their early stage investors. They can either pursue an IPO, or they can pursue a sale of the company. An inhospitable IPO environment sends more early stage companies toward a sale process and away from the IPO alternative, and that is exactly what we have seen in recent years.

This matters a lot because IPOs play an important role in fostering innovation and job growth. As President Obama said when he signed the JOBS Act into law, "New businesses overall account for almost every new job that is created in America, and going public is a major step toward expanding and hiring more workers for those companies."

The IPO on-ramp in Title I of the JOBS Act is an important step in making it easier to go public while maintaining important investor protections and providing significant cost savings in the IPO process.

The second point I would like to address is what else we can do to help IPOs. We can return to bedrock principles of Federal securities regulation. From the beginning, Congress has mandated a disclosure regime rather than merit regulation. My mentor and former partner, John Huber, used a memorable anecdote to contrast disclosure with merit regulation. John is well known for a distinguished career and his distinguished service as Director of the SEC's Division of Corporation Finance, a disclosure regulator. But earlier in his career, he had worked for a State securities commission, a merit regulator.

His coworkers at that State commission proudly refused to approve the shares of an untested, upstart company whose name today everyone in this room would recognize. They had rejected that company's request to sell shares to residents of their State because the CEO's compensation was too high.

"What was the IPO price?" John asked them. Answer: $22 per share. "Well," John responded to his colleagues, "the stock is now trading at $60 per share, so how exactly did we help investors in our State by preventing them from buying at $22?"

That anecdote sums up merit regulation, and it highlights the benefits of a disclosure regime that lets investors choose the winners and losers.

The third point I want to make is about disclosure and what information companies must provide to investors in a regime that takes the path of disclosure rather than merit regulation. The tried and true answer to that question is that disclosure of all information that is material is required. Well, anyone who has looked at an IPO prospectus recently may wonder whether we have gone far afield from that central principle of disclosing material information. An IPO prospectus today is a lengthy and detailed document running as much as 200 pages or more, often. Brevity may be the soul of wit, but it is hardly the hallmark of an IPO prospectus.

A balanced and reasonable approach to materiality is critical to the success of any disclosure-based regulatory regime. An avalanche of trivial information obscures truly important information and does nothing to increase the protections to investors.

My last point is about risk. It is a simple fact of economic life that not all IPOs succeed. Any commercial enterprise that can earn a profit can also earn a loss. Like any business, a newly public company may or may not make money for its investors. For precisely that reason, the cover page of every IPO prospectus today says this is our initial public offering. No market currently exists for our shares, and the prospectus has many pages of detailed risk factors highlighting the risks that relate to the company and the offering.

In addition to transparency, our capital markets must offer investors the opportunity to take risks. Risk-free capital markets have no future, as SEC Commissioner Daniel Gallagher recently said. Even if we could create risk-free capital markets, he said, they would not offer enough upside to attract companies or investors because investors would do just as well or better putting their money into savings accounts or Treasury bills.

Thank you very much. I welcome your questions.

Chairman REED. Thank you very much, Mr. Trotter.

Mr. Moscovitz, please.

STATEMENT OF ILAN MOSCOVITZ, SENIOR ANALYST, THE MOTLEY FOOL

Mr. MOSCOVITZ. Mr. Chairman and Members of the Committee, I want to thank you for the opportunity to offer testimony and recommendations today. My name is Ilan Moscovitz, senior analyst for The Motley Fool.

Founded in 1993, The Motley Fool's purpose is to help the world invest better. Millions of individual investors rely on The Motley Fool not only for guidance on how to manage their money, but also as an advocate for their rights as shareholders. For years we have worked to create a level playing field in the market. It is for this reason that we are eager and grateful to discuss whether the IPO process is working for ordinary investors.

It goes without saying that IPOs are critical to both developing public markets and helping businesses raise the capital they need to grow and hire.

From our vantage point as retail investors, the overarching problem with IPOs is that there is an imbalance of both information and access. Although issuers and venture capitalists ultimately depend on us retail investors for capital and for liquidity, the deck is stacked against us in at least two major ways.

First, insiders, underwriters, and their favored clients have access to more and better information than do ordinary investors. This gives them an advantage in estimating a company's fair value. Reports of Facebook's recent IPO provide a prominent example of this.

Second, there is unequal access to shares. The initial offering is traditionally limited to preferred clients of underwriters. By the time we can buy shares, there has already been a significant markup. It is estimated that from 1990 to 2009, the first day pop averaged 22 percent, totaling $124 billion. That $124 billion did not go to the companies coming public but to friends and other clients of the underwriters.

Unfortunately, the IPO process is likely to get worse for individual investors as a result of the recently passed JOBS Act. The on-ramp section of the Act is intended to spur economic growth by lowering the bar that a company must meet in order to go public. But weakening reporting requirements means less information for investors and a lower-quality pool of IPOs. Think more Pets.com than Google.

When we lost faith in the quality of IPOs in the late 1990s, IPO volume crashed 75 percent in 2001. It is worth pointing out that IPOs doubled from that level following the Global Analyst Research Settlement and passage of Sarbanes-Oxley—reforms which addressed some of the worst abuses of the dot-com bubble and ensuing years. But the JOBS Act undoes many of these reforms for nine out of ten companies coming public.

To remedy these problems, our objective should be to level the playing field and restore trust in the IPO process by maximizing transparency and useful disclosure. Here are three recommendations:

First, extend the application and enforcement of regulation fair disclosure to the beginning of the IPO process. This will help to improve the flow of information to all investors and reduce one of the most preventable information asymmetries—between underwriters and their favored clients versus ordinary investors.

Second, require that companies and underwriters allocate shares in the initial offering in a more inclusive and efficient manner. Companies like Google, Morningstar, and Interactive Brokers have successfully employed variations on a Dutch auction process, which gives all investors the opportunity to participating at buying shares at the same price, under an equitable plan of distribution. An added benefit is that it lowers the cost of going public for companies by more than half.

Finally, fix the most troubling portions of the JOBS Act from the retail investor's perspective. While there are a number of improvements that could be made, if you are looking for the most straightforward remedies, here are two:

One would be to decrease the size threshold in the emerging growth company definition in order to increase the amount of information available to investors, as the Chairman has previously recommended. The current definition needlessly encompasses virtually all IPOs.

A second remedy would be to implement a lockup period covering pre-IPO insiders which would extend from the offering to at least 180 days after an issuer is subject to normal reporting requirements, similar to common practice before passage of the JOBS Act. This will better align the incentives of insiders and ordinary investors. It will also help to ensure that any capital raised via the emerging growth company exemption serves its intended purpose by flowing to the company and not to insiders exiting on the IPO on-ramp.

As the IPO process currently stands, ordinary investors have unequal access to information and unequal access to the market. We are asking for a level playing field, disclosure, and transparency.

We believe that the lack of these qualities is what is most troubling about the IPO process right now.

I appreciate the opportunity to submit testimony on how IPOs affect ordinary investors and would be happy to answer any questions.

Chairman REED. Well, thank you all very much for the very excellent testimony, both your written testimony and your comments this morning.

Let me begin with a question for the whole panel, and it focuses on the issue of how do we best protect the retail investor given that the prevailing model, with variations now because of the JOBS Act, is the book building where managers of the IPO with clients and—as the theory—in order to advance price discovery, conduct all these roadshows, et cetera, but as the Facebook IPO suggested, some critical information, particularly at the very last minute, was available to favorite investors and not as widely disseminated to the public. So I just want your thoughts, each one of you, about if we are going to involve retail investors, how do we do it in a way that they are confident they are getting a good deal and they will continue to invest in IPOs? Dr. Sherman.

Ms. SHERMAN. Certainly, it is important to level the playing field in terms of information, and I was very surprised with Facebook that analysts were allowed to talk to institutions but not individuals. I can see why that is there, because individuals, if they are allowed to be given these forecasts—because it was not hard information; it was expectations of the future—individuals might not understand that these are speculative and they might not be able to appreciate it. But I do think the same information should be available to everyone.

One of the unusual things about the U.S. is the quiet period regulation, and as Joel said, it's disclosure, not merit. So it is very important that we try to give everyone the same access to information, and I would second what Lise said about the Q&A from the roadshow. I think that should be available even to retail.

Chairman REED. Let me just follow up. Under the JOBS Act, there is a loosening of the analyst's role, as I read the Act, that they now can be—unlike the universal settlement that Mr. Moscovitz talked about, they now can be sort of compensated or at least it is not the strict tall wall between the analyst and the promoters of the—is that accurate from your reading of it?

Ms. SHERMAN. Mr. Trotter would probably be——

Chairman REED. Well, if you do not know, that is fine.

Ms. SHERMAN. I do not know.

Chairman REED. Ms. Buyer, your comments on the general question.

Ms. BUYER. On the follow-up question or on the whole question?

Chairman REED. The whole question.

Ms. BUYER. On the whole question. Number one, let us all remember that individuals do have the ability to participate in IPOs through mutual funds. The favored clients we keep talking about are really those big firms that have aggregated many thousands of individuals' investments. So the firefighters and the teachers all actually do get to participate in IPOs, just through the screen of a professional investor.

The equal distribution of information is difficult, and I understand this is not about Facebook, but let us remember that everyone had access 2 days before that deal to the information that General Motors was pulling their advertising. That was a huge material piece of information that did not seem to in any way quell the enthusiasm for the IPO.

The issue at hand in that particular case was Morgan Stanley's estimate, which, of course, Morgan Stanley offered to the clients who pay them. The estimate is a product that Morgan Stanley sells to its customers, and I do not know that we ought to be regulating what information investment companies can share with their paying clients. I think this is a little bit of a slippery slope, and if we insist that all investment banks give their estimates, which are costly to develop, to everyone, what incentive do the banks have to come up with estimates at all?

The JOBS Act issue that I find of greatest concern—and you mentioned the Global Research Settlement—is that many banks are still bound by that agreement. So the analysts of the banks who have the most information about a potential IPO are still restricted from talking. The only ones who can now publish research are those who are farther away from what is actually happening, and I am not sure that that serves anyone's purpose.

Chairman REED. OK. Mr. Trotter.

Mr. TROTTER. Well, as I indicated in my written testimony, I am not in a position to talk about any particular IPO or company. But I will say that in the area of analyst research, by far and away all of the protections that were developed in the last decade remain in place and are unchanged as a result of the JOBS Act. There were some changes, and many of those changes relating to that area still need to be implemented through FINRA interpretation and other interpretation by the regulators in that area.

Chairman REED. Mr. Moscovitz, your comments.

Mr. MOSCOVITZ. With respect to the Global Analyst Research Settlement, yes, that is my understanding as well. One concern with the changes that were made in the JOBS Act is that if you allow analysts to meet with prospective clients, there is a possibility you can have analysts meeting clients—meeting companies that want to come public, and that way the underwriters can say, hey, here is our analyst, he has got a nice suit, he will write nice things about your company, and he will give you a strong buy recommendation. Obviously, during the 1990s, lots and lots of companies were coming public, and they were indirectly promised that they would get good buy recommendations from analysts.

And then with respect to Facebook, I agree the problem is not that shares went down because that can happen in any IPO. I would just say that there is a problem with equal access to this information. When reports from analysts are issued by analysts who have special access to management, they can get information that is not really available to all investors, and when you see something like Facebook, there is a problem where you have multiple analysts from various underwriters who all cut their estimates from pretty much the same number to pretty much the same number. You have reports that people from Facebook may have indicated to analysts that they should go over their estimates. And meanwhile the public gets sort of some vague line in a massive—S–1 amendment about our subscribers are continuing to grow at a faster pace than our revenue. So the quality of information that is being presented to prospective clients of the underwriters just is not on the same level as the information that investors would have if they have to dig through the S–1 to try to discern what that means.

Chairman REED. Dr. Sherman, you point out that in other countries the retail investors do not engage themselves in the price discovery and price setting, that is restricted, too. And I presume from your comments that you feel that that model is an inappropriate way to set prices. But many countries have a specific tranche for retail investors in which they can buy at basically the same price. Can you comment about how effective and successful that is? Is that something that we should look at in terms of our approach to IPOs?

Ms. SHERMAN. I would like to see it considered here, especially for larger offerings. I think with smaller offerings, a lot of the smaller IPOs are already marketed more to retail. But for larger offerings—and I contacted Facebook. They never got back to me, but I tried to talk them into doing this. That way everyone has an equal chance to participate.

When I lived in Hong Kong, I went in and placed orders. All you needed was a Hong Kong ID number, and everyone had an equal chance. But the problem that has occurred with auctions is that when you get—retail investor demand is very uncertain. You can get these floods of investors coming in and pushing the price up to unsustainable levels, and then people lose money, and then the retail go away again because they are scared of the process. So there needs to be some coordination, and we can easily then open up allocations and give everyone a chance without disrupting the process, which is not good for anyone.

Chairman REED. And one of the other aspects of the American model, for want of a better term, is the roadshow in which analysts are able to quiz management. As Ms. Buyer suggested, it might be appropriate to consider making that much more accessible. And I think in Facebook there was a version put on the Net, but it neglected to have the questions of the analysts, which was probably the most important part of the demonstration.

Is the roadshow process the best mechanism in your view?

Ms. SHERMAN. I think that is important, and I would like to see the question-and-answer filmed. If you look at why investors go to the roadshow, it is to see the management in action, to see how they respond to tough questions, to get a feel for the people, because you are not just investing in the idea or the product; you are investing or betting on the management team. And Facebook, their first day for the roadshow, replaced a lot of the Q&A with this 30-minute video, and investors were very unhappy about that. And by the next day in Boston, that was gone because there is—I have watched the online roadshows, but then you are seeing management scripted and rehearsed and filmed. It is just different to see them on their feet responding to questions, and retail investors should get the chance to do that.

Chairman REED. Thank you.

Mr. Trotter, we have got the JOBS Act now, and you suggested it is opening up new opportunities. But is one opportunity, as has been at least suggested in reports by the *Wall Street Journal,* to take a shell company, effectively, that is already registered, presumably, and simply do some—and you are the expert, not I, but a reverse merger, and so you do not have to have audited—in some cases, audited financial statements or you do not have to have the rigors of Sarbanes-Oxley, yet you do not go through the traditional IPO process of the book building, the analysis, or offering. Is that something that concerns you about how, you know, either willingly or unwittingly, this new Act could be used.

Mr. TROTTER. Well, Mr. Chairman, many of the things that you just said about shell companies are, in fact, true. They were true before April 5, 2012, and they continue to be true today. The JOBS Act did not really change the dynamic with shell companies. They have always been a part of the system. They have always been subject to SEC review, so before they can register, they go through the same type of rigorous SEC review process where they have to provide disclosures to their investors. And in terms of Sarbanes-Oxley compliance by shell companies, they almost exclusively are smaller reporting companies, so they have already been exempted under Dodd-Frank from the internal control audit required by Section 404(b) of Sarbanes-Oxley. And so none of those aspects relating to shell companies has changed as a result of the JOBS Act.

Chairman REED. But one of the—and this might be the most ironic aspect here of the JOBS Act, there is nothing in the bill that requires any creation of jobs to qualify for all the protections and all of the benefits of the JOBS Act. Is that accurate?

Mr. TROTTER. I think the premise underlying the IPO on-ramp is that, again, going back to the competitive nature of the capital formation process and the fact that if you have an early stage company that needs to provide a return to its early investors who bet on the company when it was just an idea, that type of a company can pursue one of two paths. It can sell the company to an acquirer and be part of a larger enterprise and get absorbed and have redundant positions eliminated in the short term, or it can raise its own capital to be independent. And in raising your own capital to become an independent enterprise, you are going to grow the business. And when you do that, you are going to need more employees to help you run your growing business. So you are going to need to hire people. And, in fact, if you—you know, you can think of cities around our Nation that are almost synonymous with certain major companies today, and yet in almost every case they started out as fledgling enterprises that nobody would have guessed would have become household name companies today.

So when you think about the connection between IPOs and job creation, you can just think of—pick your favorite city, whether it is Seattle or Cupertino or Austin, Texas, and you will think of a company that has changed the landscape of that city.

Chairman REED. But, specifically, all of the provisions of the JOBS Act can be accessed by companies who do not grow one additional job. They can avoid Sarbanes-Oxley reporting. They can do this until they get to the size of $1 billion in revenue. And it would seem to me that a company that has $1 billion in revenue could afford to have audit standards and could afford many other things which would protect whatever their shareholders. But the reality is that you do not have to have one extra job to be an emerging growth company. Is that correct?

Mr. TROTTER. Yes, sir. And several points in response to your very good questions there. The profit-and-loss system of the capital markets and our free enterprise system entails both profit and loss. We cannot—this goes back to the distinction between merit regulation versus disclosure, and people now in hindsight talk about certain dot-com companies and how they are examples of bad ideas.

Well, nobody knew for sure at the outset whether they were bad ideas. The investors had to choose and pick the winners and losers. And some of those companies are long forgotten, but many of those companies are around today and have even created new industries and changed the way that we purchase products. So that is one point in response.

Another one, on the issue of Sarbanes-Oxley complaint, remember that the President's Jobs Council, headed by Mr. Immelt from General Electric, recommended a permanent exemption from Sarbanes-Oxley 404(b) compliance, the internal audit attestation requirements of Sarbanes-Oxley, for all companies below $1 billion in revenue. So the JOBS Act provision that gives this on-ramp of 1 to 5 years, depending on the size of the company, is much more limited than that recommendation from the President's Jobs Council. And, again, any newly public company has up to 2 years under prior law before it has to comply, so it is really changing 2 to 5 in terms of Sarbanes-Oxley internal control attestation.

Chairman REED. But one could argue, given the 2-year exemption for all companies before the JOBS Act, that the requirement to eliminate that for the initial public offering and for the 2 succeeding years might have been a little bit more, you know, generous than was necessary. We already recognized in Sarbanes-Oxley that companies coming online may not be as well prepared.

Mr. Moscovitz, your comments about this whole area.

Mr. MOSCOVITZ. Well, with regards to the JOBS Act, you are referring, I believe, to some of the reporting in the *Wall Street Journal's* "Meet the JOBS Act's Jobs-Free Companies," about the JOBS Act, jobs-free companies, as well as some other articles that are describing how lots of companies were describing themselves as blank-check companies or trusts and the like. There is a quote in that article, actually, from the Nasdaq vice chairman who lobbied hard for passage of the JOBS Act, and he said that he did not think that anybody was thinking that this was going to be applied to reverse mergers and the like.

And I guess I would say that we should be very careful about what the emerging growth company exemptions are being used for. We have seen, as you know, trouble in China, for example, with their reverse merger disaster. Reporting in China and the accounting standards in China just are not at the same level that ours are. And we saw when investors very suddenly realized this, very suddenly acted on this, starting in late 2010, shares of 93 percent of these companies fell by an average of 50 percent for Chinese emerging growth companies. Any of them that wanted to raise capital after that point, it became very difficult to do that. You have companies that are presumably growing at, 50 or 60 percent per year that have a PE of 2. The only reason that happens is if people just believe that they cannot trust any of the numbers coming out of China. If you are investing in a small Chinese company right now, the first risk factor you consider is whether or not it is a fraud.

So I would just say that we should be very careful—we do not want to move in that direction.

Chairman REED. Let me just ask you, Mr. Trotter, you brought up merit regulation, which is, to my understanding under the Federal securities laws, there is not merit regulation. Is that correct?

Mr. TROTTER. That is correct, Mr. Chairman. It is a matter of degree. When you require—there are instances where disclosure can veer into merit regulation, depending on whether the requirement is simply to provide all investors with all material information about the company, that would be pure disclosure. Requiring specific disclosure about specific topics or requiring companies to comply with substantive standards that are not simply about disclosing to investors all of their material information, then you are veering into merit regulation.

Chairman REED. Well, my understanding—and again, it might be outdated—is that the SEC cannot refuse a registration because they object to a business model or anything else. They just can require you to spell it out in excruciating detail. And that is not merit regulation. So it is setting up sort of a straw man, I think, and saying, well, the fight is against merit regulation and disclosure, I am for disclosure but not for—we do not have merit regulation. Dr. Sherman, do you consider us we have merit regulation here for Federal securities laws?

Ms. SHERMAN. No, I do not think so, and that is very important. Having seen a lot of other countries, particularly in Asia, they give investors much less information and instead rely on metrics such as has the company earned a profit for the last 3 years, and if not, you cannot go public. And it closed out a lot of good companies, and yet does not improve pricing because people do not have enough information to judge. So I think a strength of the U.S. is that we do have disclosure and not merit.

Chairman REED. And because of that, there is a strong emphasis on very thorough disclosure, and as Mr. Trotter points out, it leads to long prospectuses. But my feeling—and I will ask both you and Ms. Buyer—is that these prospectuses are read very closely by very sophisticated institutional investors, in particular in preparation for an IPO, so that the information is not just gratuitous or ignored. I mean, frankly, if I was presented 200 pages, I would quickly—Evelyn Wood would be proud of me, but when you have these roadshows, when you have this process of iteration that these prospectuses ultimately are very, very useful, I presume—is that accurate?

Ms. SHERMAN. Well, I think so. I tell my students in my IPO and venture capital class that you get more information when a company does an IPO than at any other time. There is just so much in the prospectus. And when we do case studies, we go through the risk factors, and they will have stories and extra detail. You find out a lot more about how the company does business, how the model works, from all of the detailed disclosure. And you do not necessarily have to read all of it, but you can look through and look for what you need, and hopefully it is there.

So I think that is very important. I would hate to see us loosen that.

Chairman REED. Ms. Buyer, your comments.

Ms. BUYER. Yes, as an institutional investor, we would read the prospectus cover to cover prior to meeting with the company so as to be able to use the meeting time most effectively. There is a tremendous amount of information available, and, yes, it is written sometimes in arcane form, but it is tremendously important and brings up another question about the JOBS Act in that, of course, people now have—investors have less time to study the prospectus given that they can now be filed confidentially.

Chairman REED. Yes. What is your reaction to the confidential filing? How is that going to practically impact an institutional investor like you who wants to invest perhaps but also, you know, theoretically is helping to find the right price, because you have all these details? What effect will that have practically on you?

Ms. BUYER. I would say mostly institutional investors read the prospectus when it is in its final form. So for the most part, the confidential filing does not much matter.

However, from time to time, the initial filing differs quite widely from the final filing thanks to commentary from the SEC, and investors learn a great deal in watching the changes. An example would be the company Groupon, which suffered mightily between filing its initial S–1 and the final S–1, as it became apparent that the company's relationship with the accounting rules was somewhat flexible. I would argue that that knowledge, watching that process, was very valuable to institutional—and retail—investors.

Chairman REED. It just strikes me, too, that, again, you know, we have a system which is based on transparency, disclosure. Basic economic theory is perfect information is what drives competitive markets. And here we have basically said this is all going to be confidential until very late in the process, et cetera, and I do not see how that accomplishes significantly informing investors, either institutional investors or retail investors.

Ms. BUYER. Mr. Chairman, I would agree with you, and I would further comment that by allowing filing companies to keep those facts hidden until later in the process, while concurrently encouraging research provisions that allow research to be published during that period, we are actually asking investors to make their decisions based on opinion as opposed to the facts that they could have had if they could read the filings throughout the process. We have exactly flipped the arrangement I believe should be in place.

Chairman REED. Mr. Trotter, comment, because I know you have a position on this.

Mr. TROTTER. Well, I guess what I would say is that this was—the confidential submission process is based on a historical practice at the SEC accorded to foreign private issuers, and so that is the genesis of the idea. Unlike in the case of foreign private issuers, though, in the case of emerging growth companies under the JOBS Act, they are required to provide the original submission plus all amendments that resulted from the SEC review process approximately a month before the IPO will price. And so all of the information that Ms. Buyer was referring to is publicly available in sequence, and investors will have a month to pore over all of that information.

Chairman REED. Let me ask you another question, because there is a presumption that the JOBS Act—proponents would argue that it reduces costs. In fact, there are estimates, I think, of 30 to 50 percent of the cost. I think that is what you were suggesting in your testimony. Where do these cost savings come form? Investment banking fees you believe will be lowered because there is not the requirement to do these elaborate roadshows? Is it because information—where are the savings coming from?

Mr. TROTTER. It is principally from two sources. The data is based on surveys of pre- and post-IPO CEOs who responded to the specific proposals and provided estimates of how much cost savings they would recognize. But it is first through the deferral of the Sarbanes-Oxley internal control audit requirement, which, again, for companies of this size, the President's Jobs Council recommended a permanent exemption from Sarbanes-Oxley internal control audit attestation; and then second from the benefits available from the scaled disclosure system that the SEC has adopted for smaller reporting companies. And so in the case of—you asked about merit regulation versus disclosure. If you think about some of the disclosures that are required of very large enterprises and applying those disclosure requirements to much smaller enterprises—and I think it is worth noting that all of the companies that are captured within the definition of "emerging growth company" represent approximately 3 percent of total market capitalization.

So there is a concern expressed by my fellow witnesses here that the definition is too broad, but I think you have to take into account the fact that that definition captures roughly 3 percent of the total market capitalization of the United States. So that is not a very large number.

Chairman REED. This is one of the those issues that depends on what you are measuring and what you are comparing it to.

Mr. Moscovitz, my sense was that having limits of up to $1 billion in revenue captures a lot of companies in the United States.

Mr. MOSCOVITZ. Right. Well——

Chairman REED. Not just in capitalization but just sheer numbers of companies.

Mr. MOSCOVITZ. Right.

Chairman REED. And probably captures every potential IPO company.

Mr. MOSCOVITZ. So I am not familiar with the 3-percent number, but it could be right. In terms of the IPO Task Force, they said it was 14 percent of companies, but in terms of IPOs it is about 90 percent, maybe——

Chairman REED. So, essentially, the world, when we are talking about IPOs, it is about most of them, 90 percent of them.

Mr. MOSCOVITZ. Right.

Chairman REED. And the issue about cost savings, this goes to—and Mr. Trotter I think pointed out very accurately, one, it is the internal controls; and, two, it is sort of disclosure requirements that one could argue are more appropriate to large corporations, et cetera. But, still, it goes to this issue of disclosure and governance of the company. That is where the savings are going to be. I do not think we will see any savings from investment banking fees or from anything else. For the investing public, both the initial investors and the ongoing investors, does that make sense?

Mr. MOSCOVITZ. The investment banking fees are substantial for IPOs, and it would be nice if we could find ways to reduce that. In terms of the compliance costs, you know, a company that is doing $1 billion in sales whose market cap is $700 million, which is, you know, the upper limit here, can really afford to comply with Sarbanes-Oxley.

Chairman REED. Well, again, having participated with both Chairman Sarbanes and Chairman Oxley in the legislation, this was a direct response to abuses and lack of controls and those things that ultimately cost shareholders dearly when the companies cratered because they were not doing things they assumed—the shareholders assumed were doing routinely adequate audits.

Well, I have had the rare opportunity to be able to engage with a splendid panel of experts. We have learned a great deal. Let me just simply ask—I think it is appropriate—if there are any concluding comments, Dr. Sherman and Ms. Buyer, Mr. Trotter and Mr. Moscovitz, about the issue advice to us going forward. Dr. Sherman.

Ms. SHERMAN. I think, and I tell my students, that one of the great strengths of the U.S. economy really is the fact that we have focused on giving investors the information they need and letting them decide for themselves. So many countries take a much more paternalistic approach, and you end up losing a lot of great companies and funding a lot of bad companies that way. So I hope that the U.S. will focus on giving people as much information as possible, and then having them take responsibility for their decisions.

Chairman REED. Ms. Buyer, please.

Ms. BUYER. I would agree with Dr. Sherman's comments all the way along the way. I would say that the promise of a public offering spurs many individuals all over the country, but certainly in Silicon Valley where I live, to try to make businesses out of new ideas that can turn into large, new companies that can employ thousands and thousands of people. The markets are tremendously important, and mostly not broken. Mostly they suffer through swings reflecting risks in the economy and marketplace.

That said, I think there are a few changes that probably could improve the process, and, again, I strongly recommend many aspects of the JOBS Act be reconsidered, as much of what it has accomplished is only to transfer risk, earlier in the process, from private investors to public investors, which, as you point out, does not actually create any jobs.

Chairman REED. One other thing, too, and this is the potential for not just the misallocation of resources but for fraud. Does that concern you?

Ms. BUYER. Yes. Certainly, there will always be on the margins some fraud, but we have not talked—and another time probably—about crowdfunding, which is certainly very interesting but also enables significant transfer of funds between informed investors and uninformed investors, without much regulation or control. Because we have pushed back the size at which a company needs to reveal its information publicly from 500 shareholders to 2,000 shareholders, we will probably see much more activity on the secondary markets. And, again, there are few requirements for information, and, in fact, trading on inside information in the secondary markets is perfectly legitimate. So without going on too long, yes, I think we have some fraud issues coming.

Chairman REED. And there is a further complication which complicates our life in many different dimensions; that is, with the Internet-based economy, these companies can be virtual and located far beyond the reach of anyone, which further makes it particularly complicated from the aspects of a potential source of, you know, get-rich schemes. I have this terrible feeling that the first thing on the Web page would be, "Congress just recently authorized this tremendous advantage. Please, take advantage of it. Your Congress"—and I do not want to be too melodramatic, but that concerns me.

Ms. BUYER. Of course. Years ago, there was a cartoon in the New Yorker that showed a hound sitting at a keyboard, and the caption underneath was, "On the Internet, no one knows that you are a dog."

Chairman REED. Yes. Or very short. Anyway, Mr. Trotter.

Mr. TROTTER. The IPO Task Force came to its work with the view that the IPO process is critical to capital formation, and particularly early stage investing, and that that is all connected to innovation and job creation ultimately by the part of the private sector that really creates jobs. So that is our focus.

Then just a couple of points again on risk. You cannot remove risk from the system because if you do, you remove the opportunity to make a profit. And so the solution is not to look for ways to eliminate risk from the system but to make the system fair, and that is disclosure. But when you look at disclosure, what are you requiring disclosure of? Is it the type of information that the very largest companies in the United States have to provide? Or is it the more scaled disclosure that focuses on what is material to an investor in an early stage company? And if you fail to recognize that distinction and apply very detailed disclosure rules across the board, then I think that you do have a system that veers into merit regulation of smaller companies.

Chairman REED. Thank you very much.

Mr. Moscovitz, you have the last word.

Mr. MOSCOVITZ. Generally speaking, it is not a good idea for investors, individual investors, to get involved in companies too early. After a very brief period of time of flipping stocks that occurs at the beginning of an IPO process IPOs tend to actually underperform, and their share returns tend to be negative.

The concern is that we do not want IPOs to be a process where companies are coming public with the intention of getting shares to favor clients of the underwriters so that they can flip the stocks over to unwitting investors who do not understand which companies are poor quality and which ones are not. So I would say at a minimum it is important that we have an equitable distribution of useful information.

I agree that these prospectuses are very detailed, there is a lot of good information presented there. It is very difficult to go through them and find out—you know, pick through it and figure out what stuff is really important. The Facebook example, you really had to read between the lines to figure that out. And so I think at a minimum it would make sense for investors to have access, the same kind of access that clients of the underwriters have.

And then one final thing with regards to fraud. You know, a lot of former securities felons have raised concerns about the JOBS Act, so I would just say that we need to think carefully about that. I have various recommendations with regard to crowdfunding. I can talk about them, but I could also just submit it to you later.

Chairman REED. Thank you very much.

I thank all of you for your testimony. It has been very thoughtful and very helpful. My colleagues may have their own written statements, which they would be allowed to submit for the record, and I would ask them to do so before next Wednesday, June 27th. All of your testimony will be made part of the record. Some of my colleagues may have written questions. We may have additional written questions. We will get them to you as quickly as possible and ask you to get them back to us as quickly as possible so we can conclude the record within a very short period of time and inform the Chairman and the other Members of the Committee of this hearing.

With that, let me again thank you for excellent testimony, and I adjourn the hearing.

[Whereupon, at 10:40 a.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF ANN E. SHERMAN

ASSOCIATE PROFESSOR OF FINANCE, DEPAUL UNIVERSITY

JUNE 20, 2012

Introduction

Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, I want to thank you for inviting me to testify. Funding young, innovative companies is crucial for economic growth, and I am honored to have been asked to participate in this exploration of the initial public offering (IPO) process.

The Role of Investors, and How the IPO Process Differs From the Secondary Market Process

The central point to remember about the IPO process is that IPOs are difficult to price. The recent performance of Facebook's stock reminds us that the aftermarket price path of an IPO stock is not predetermined or easily predicted. Recent problems tempt us to try something new, but we should first look at the evidence of what has and hasn't worked in various countries, since there has been much experimentation with IPO methods in the last three decades.

Currently in our system, institutional investor feedback plays an important role in the price-setting process, as evidenced by the price revision that occurs after the road show. The issuer and its underwriter estimate the offer price by setting the initial price range, but then the shares are marketed to investors, feedback is gathered, and the final price is set, a final price that is often substantially different from the initial estimate. Only about one-third of U.S. IPOs end up being priced within their initial price range.

In research with Dr. Sheridan Titman of the University of Texas at Austin, we modeled the process by which the underwriter forms a group of regular investors to participate in this process, showing that control of the pricing and allocation process allows the underwriter to induce investors to pay attention, evaluate the offering and provide feedback. [1] Essentially, the average first day return or "pop" of an IPO, which academics call underpricing, allows the underwriter to buy the time and attention of institutional investors, inducing them to attend the road show and listen to the pitch. By underpricing IPOs on average, the underwriter cannot guarantee that investors will like every offering, but it can at least induce them to show up and consider each offering. Without this process, firms risk being overlooked by the market and thus failing to attract a following.

Thus the U.S. IPO method, known as book building, allows the underwriter to coordinate offerings and reward regular investors that contribute to the process. Institutional investors have the expertise and resources to evaluate IPO shares, are more likely to participate regularly in IPOs, and are more likely to be continued followers of the shares in the secondary market, thus providing future liquidity. Ordinary individual investors, as a group, may not be equipped to play the same role as institutional investors, and any regulatory changes that are made to allow greater retail investor participation should take these differences into account.

How Ordinary Investors Participate in IPOs in Other Countries

In research with Dr. Ravi Jagannathan and Dr. Andrei Jirnyi, both of Northwestern University, we documented the IPO methods used in countries around the world. [2] In the early 1990s, the U.S. book building method was rare outside North America. By the end of the 1990s it was common around the world, having proved more popular than other methods. However, what most countries have adopted is not "pure" book building but a hybrid, or combination, of book building with a separate tranche for ordinary investors. This separate tranche allows all ordinary investors an equal chance of getting shares, but without disrupting the central IPO process.

Thus, of all the countries around the world with relatively active IPO markets, the U.S. is one of the few that does not have an open, transparent way to allow ordinary investors to participate. It is important to note that there are two ways

[1] Sherman, Ann, and Sheridan Titman, 2002, "Building the IPO Order Book: Underpricing and Participation Limits With Costly Information", *Journal of Financial Economics* 65, 3–29. Earlier work on developing the conditions needed to induce investors to accurately report their feedback is in: Benveniste, Lawrence, and Paul Spindt, 1989, "How Investment Bankers Determine the Offer Price and Allocation of New Issues", *Journal of Financial Economics* 24, 343–361.

[2] Jagannathan, Ravi, Andrei Jirnyi, and Ann Sherman, 2011, "Why Don't Issuers Choose IPO Auctions? The Complexity of Indirect Mechanisms", Unpublished working paper, available on the Social Science Research Network at *http://ssrn.com/abstract=1330691*.

to allow such participation: by allowing ordinary investors to also help set the offer price, or by restricting them to only ordering shares. The second approach—allowing ordinary investors to buy shares but not to set the price—is now common around the world. The first approach—giving all investors an equal voice in the price-setting process, usually through an auction—has been tried in at least two dozen countries, and has led to major problems.

Including ordinary investors in the price-setting process on an equal basis has led to dramatic swings: in some cases, large numbers of investors have flooded into the IPOs, many bidding high prices to be first in line for shares and thus driving the offer price up to unsustainable levels; in other cases, participation has been unexpectedly low. In some countries, such methods performed adequately for a time, until finally enough investors got excited and poured into an offering, pushing the price up to the point that the stock later crashed on the aftermarket. Such crashes then led investors to stay away from later IPOs, leading to undersubscribed offerings.

In secondary market trading, there is at least the possibility that sophisticated investors might be able to take advantage of any mispricing and, in the process, help to eliminate that mispricing. With IPOs, on the other hand, our research shows that even sophisticated investors are harmed by the uncertainty created by waves of unpredictable retail investors, and ultimately the issuers have been harmed and discouraged by the risks of such methods. Our research shows that when issuers have gained experience with both methods and then are given a choice between a method that allows ordinary investors to participate in price-setting, and a method that allows the same investors to participate in allocations but not in price-setting, issuers have consistently chosen a method that puts the offer price in the hands of professionals.

On the other hand, many IPOs in the U.S. have been successfully marketed primarily to retail investors. The key is that the book building method gives the underwriter discretion over which investors can participate, and how much influence they can have over the price, even when the shares are targeted mainly at retail investors. Issuers and underwriters currently are allowed to choose which offerings to market to retail rather than institutional investors, since institutional investors do not want to get involved in smaller offerings, while retail investors can more readily understand the business model of, say, Netflix or Krispy Kreme than that of a biotech company.

My concern is over methods that force the underwriter to give equal weight to all orders, rather than allowing underwriters the kind of discretion they currently have in terms of who can participate. Therefore I am not advocating that all retail investors should be forced out of the pricing-setting process, only that, as now, we do not take away the discretion of the underwriter in terms of pricing the offering or allocating shares in the book building tranche. Issuers should still be allowed to place smaller offerings with retail investors in a flexible manner, even if the U.S. chooses to require a certain proportion of shares in larger offerings to be placed with ordinary investors in a more open, transparent but rigid way that guarantees all retail investors a chance to receive shares.

The method that has been successful in other countries is to give all retail investors the opportunity to place orders in a separate retail tranche where those investors are guaranteed an equal chance at getting shares, at the same price paid by other investors in the offering.[3] The orders are similar to noncompetitive bids in Treasury auctions, in that investors are not forced to specify a price. The proportion of shares to be sold in the retail tranche is announced in advance, so that there are no last-minute surprises. If demand is greater than supply, the shares are allocated through balloting (basically, a lottery). If demand is less than supply, the shares may be re-allocated to the other tranche. The subscription ratio (total shares ordered relative to shares available) for the retail tranche is announced after the close of the subscription period but before the beginning of trading. Thus, everything is transparent.

I do not have strong feelings either way on whether lawmakers should require that the U.S. IPO process be opened up to ordinary investors. The concept of "fairness" is highly subjective—one could argue that it is unfair to exclude ordinary investors from the process, or that it is unfair to force issuers to include investors that are not contributing to the process. The contribution that I hope to make today is to suggest the best way for the U.S. to guarantee a role for ordinary investors in

[3] In some countries, the issuer/underwriter is allowed to discriminate based on order size. In other words, the probability of getting shares in an oversubscribed offering may depend on the size of one's order, but all orders of the same size have the same probability of getting shares.

IPOs, if and when we decide to do so. If lawmakers choose to use regulation to open up the IPO process to ordinary investors, my recommendations would be:

1. Give retail investors a separate tranche and do not force them to name a price (i.e., place a bid) in order to participate.
2. Have issuers announce in advance what proportion of shares will be allocated through this separate tranche, and require that issuers re-file if they want to go too far from the expected allocations (as is done now regarding pricing outside the current price range); However, as in most countries, they should be able to shift shares from one tranche to another if one tranche is undersubscribed.
3. Make any participation requirements flexible, or waive them completely, for smaller offerings, which are often already marketed primarily to retail investors.

Retail Investors, Private Equity, and "Crowdfunding"

The problems that have occurred when allowing ordinary investors to actively participate in pricing IPOs have implications regarding the role such investors should play in even earlier financing rounds for private companies. Private equity markets, including the IPO market, differ from secondary markets in that investors face far more uncertainty with far less available information. Even in secondary market trading, finance academics caution that most ordinary investors would be better off buying shares in mutual funds, rather than trying to pick stocks on their own. With private equity markets, small investors face much greater challenges. Venture capitalists currently play a major role in not only providing needed funds but also screening and monitoring early stage companies, and providing advice and guidance to them. Most ordinary investors are not equipped to play this role and, moreover, it would not be cost-efficient for them to attempt it. Spreading funding decisions over many small investors does not make economic sense if there is a fixed evaluation cost for each investor, particularly if those investors are relatively inexperienced and thus face higher due diligence costs. Small investors putting up just a few hundred or even a few thousand dollars each do not have the experience or the resources or the personal presence needed to screen, monitor and guide young startups.

Moreover, while "crowdfunding" sounds new and exciting and egalitarian, there's every reason to expect that such a process will result in even worse pricing of early stage private equity than of IPO shares. One example of the problems with allowing ordinary investors to participate in early stage funding is the fact that Facebook's shares were auctioned at an unrealistically high price shortly before its IPO, possibly inducing the underwriters to set an excessive offer price. Granted, there were many factors in the Facebook IPO debacle, and this hearing is not about just that one offering, but it is relevant for today's hearing to remember that, in March and April of 2012, Facebook shares were sold on SharesPost and SecondMarket through auctions that allowed the price to be set by investors. The auction price set by investors was between $42 and $44 per share, whereas even an offer price of $38 per share proved to be unsustainable. By the end of May, the shares were trading at around $28, 36 percent below their earlier auction price.

Given the many problems that have resulted from allowing small retail investors to participate in pricing IPOs, it's even less likely that such investors will be able to consistently price early stage private equity rounds without difficulties that will eventually drive those investors out of the market entirely. Thus, if we want to allow ordinary investors to participate in early stage funding, the best approach would be for them to participate through something similar to a mutual fund, where professional venture capitalists make the funding decisions and provide the extensive due diligence and monitoring needed for early stage investments.

Improving the Flow of Information to Investors

A unique feature of U.S. IPOs, relative to those in other countries, is the quiet period. This is based on the admirable goal of a level playing field, giving all investors access to the same information. However, there appear to be two areas in which investor access is not the same: road shows, and forecasts by the analysts connected to the lead underwriters.

During road shows, the issuer is not allowed to reveal new, hard information that is not in the Prospectus. Why, then, does anyone attend? Investors attend road shows largely to observe the managers, and in particular to see how they handle various questions. Although the managers are prepped in advance and have rehearsed their answers, investors still apparently find value in watching them on their feet, dealing with tough questions. Facebook's management learned this recently when, on the first day of its road show, it drastically shortened the Q&A time to instead show a video. Investors protested, and the video was dropped by the next morning. Professionals apparently value the chance to observe management in action, and ordinary retail investors might benefit from this same opportunity.

Thus, my first recommendation is to require the issuer to record and post actual road show presentations, in particular the question and answer portions, for at least two of the presentations, one early in the process and one later. Many issuers already prepare online road shows, but my recommendation is for posting actual presentations, chosen in advance and with relatively large (expected) numbers of investors, not staged videos made specifically to be posted, and not presentations cherry-picked by the issuer and underwriter later, after having filmed multiple presentations. Although this would not allow ordinary investors to see every single road show presentation by the issuer, it would give them at least as much information as the average institutional investor that attends only one particular road show meeting.

Regarding analyst forecasts, the current policy, as I understand it, is to allow analysts connected to the lead underwriters to communicate with institutional but not retail investors. There is a reasonable basis for this restriction, because these communications involve expectations of the future, not hard information regarding the company's past, and forecasts can be manipulated. Relative to institutional investors, ordinary investors may not be as aware of the speculative nature of such forecasts, perhaps making them vulnerable to overly optimistic predictions. Thus, the rationale for the current restriction is understandable, but it creates at least the appearance that institutional investors are being favored. Lawmakers should consider allowing such forecasts to be available either to everyone, or to no one.

Conclusion

Much of the growth of the U.S. economy, and of technological progress around the world, is due to the U.S. regulatory environment regarding funding of companies, a regulatory regime that has focused on providing investors with information and allowing them to make their own decisions. Many countries take a more paternalistic approach, putting more power in the hands of bureaucrats and less information in the hands of investors. I taught at a university in Hong Kong for 6 years in the 1990s and saw countries in Asia copying the outcomes of U.S. financial markets, rather than adopting the process and regulatory philosophy. I would like to see the U.S. continue and strengthen its tradition of relying on markets and giving investors the ability to make their own informed choices. Thus, further steps to level the playing field for ordinary investors in terms of information are steps in the right direction.

However, we should also recognize the differences in expertise and resources between institutional and individual investors. Lawmakers should not force issuers to give access to ordinary investors in a way that disrupts the IPO pricing process, thus adding more risk for everyone involved. If IPO issuers are required to set aside shares for ordinary investors, it should be through a separate tranche that does not directly affect the offer price, but simply allows them to participate.

Thank you for the opportunity to testify before this Subcommittee.

PREPARED STATEMENT OF LISE BUYER

FOUNDER AND PRINCIPAL, CLASS V GROUP, LLC

JUNE 20, 2012

Introduction

Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, thank you for asking me to join you today. I am honored to be asked to contribute this testimony in support of the discussion of the initial public offering process, a complicated and critical right of passage so important to many companies and to our Nation's economy.

Let me begin with perhaps the most important point . Initial public offerings are always and inherently risky. Investors in IPOs must be risk tolerant as the behavior of these new offerings are, by definition, even less predictable than the stocks of any company with established trading characteristics. These new issues are riskier than the stocks of any companies that have demonstrated an ability to handle the obligations appropriately asked of publicly traded companies. Institutions or individuals that do not fully understand and accept the fact that IPOs often involve short-term losses should not participate until the stock has "settled," usually after several weeks of trading. On day one of trading, there are no investors, only speculators.

What improvements need to be made to the process? In my opinion, the one change that could most improve the IPO process, at least with regard to individual investors, would be a simple addition to the IPO purchase process. I believe this simple step could help individual investors to better understand their investment decision. In clear and straightforward terms, we should ask every investor to accept and acknowledge the risks they are taking when purchasing a new issue. Specifically, if I could make only one suggestion, it would be this: Before confirming a buy order, in person, over the phone or online, each investor should have to read or be read a short, simple sentence, in large bold type, that states:

> I fully acknowledge that this stock has an equal chance of trading up or down from the price I am agreeing to pay. Furthermore, I acknowledge that shares of newly public companies routinely trade below their offering price at some point.

I believe a simple plain English acknowledgement of that description would both clearly warn investors of the risks and help them accept responsibility for their actions in the event that the stock does not perform as hoped. Prior to placing a "buy" order for a new issue, every investor should be required to indicate his or her acceptance of these simple statements.

Other Improvements

While the simple warning may be the most critical modification to the current process from the perspective of an individual investor, the process could also be improved with other changes. For instance, were regulations to allow it, companies could send, electronically or through brokers, a brief questionnaire to potential investors requiring them to demonstrate an understanding of what the company does and at least one risk that the company faces. The purpose of this "speed bump" would be to slow down those looking to buy a stock only because they heard it was "hot."

A third change to the process would redefine an "emerging growth company." Currently defined as an entity with gross revenues of less than a billion dollars, the relaxed reporting and filing requirements for these large businesses disadvantages investors with potential interest in those stocks. By the time a company has reached even $250 million in revenue, it ought to be able to document its processes and pay for historical audits.

In my opinion, these three could have a major beneficial impact on the IPO process.

How Secondary Markets Differ From Initial Public Offerings

The secondary market process differs in most every way. In fact there really is very little "process" in the secondary market. Sellers are allowed to trade based on inside information and buyers understand the rules are "caveat emptor/buyer beware." There are no required disclosure or marketing documents or rules about sharing the same material information with each buyer. There is usually no roadshow or chance to meet with or see a video of management. Secondary markets are for those who understand the risks of owning companies where there is little available information, are no audit requirements, no assurance that an active market for the stock will ever develop and the wherewithal to absorb a complete loss of invested funds. Investors in secondary markets agree to accept these risks believing they will be offset by outsized rewards.

Increasing the Efficiency and Transparency of the IPO Process

Information currently flows freely to those investors, both retail and institutional, who are willing to look for it. The recent advent of an online "retail roadshow" has closed a long-standing gap between the information available for individuals and institutions. However, it is not clear that individual investors are aware of the availability of these online roadshows.

One further way to improve the flow of information would be to require companies on a roadshow with institutions to offer a scheduled "ask the management" online Q&A session. During this part of the roadshow, management teams would offer answers to individual investors' questions which had submitted online. These questions would have been prescreened to prevent inappropriate queries. One could collect questions over a period of several days and then use the live session to address those asked most frequently. In order to submit a question, a potential investor would first have to have watched the retail roadshow as both a show of genuine interest and in an effort to use the Q&A session most effectively.

The Roles of IPO Market Participants

The roles of each of the following groups in the pricing and final allocation of shares on an IPO are as follows:

Underwriters

- Based on the company's finances and prospects, the current trading ranges of already-public companies that are in some way similar and overall market conditions, determine the offering range at which the IPO will be initially be marketed.
- Based on specific, aggregated, marketplace feedback from experienced investors, and in conjunction with the board of directors and management of the company going public, determine what the actual offering price will be.
- Either alone or in conjunction with management (but mostly the former), determine to which accounts the shares to be sold will be allocated.
- Commit to "make a market" or provide a liquid trading market in the security after the IPO, to insure those that seek to buy and sell can do so every day the market is open.

Institutional Investors

- To varying degrees, study the information available on the company, evaluate the prospects of the business and the price range at which the IPO is being offered to determine whether or not the offering is attractive.
- Often develop internal models and projections about the company's future financial results based on the publicly available information and on their own experience and knowledge which they use to develop a price target for the new issue to attain in a future period (usually 12–18 months)
- Provide feedback to the underwriters on the institution's level of interest at various prices in, below or above the proposed pricing range.

Retail Investors

- Limited role in the pricing and allocation process. These investors have an ability to register interest with their brokers if they have an account with one of the firms involved in the underwriting.

What Role Should Each Play in the Pricing and Allocation of IPOs?

Underwriters

As it is the underwriting banks that will actually purchase the shares from the company to be immediately resold to the institutional investors, and since the underwriters are the best source of aggregated information about market demand and historical account behavior, they are critical in both the pricing and allocation decisions in all non-Auction IPOs. Underwriters should reach the pricing and allocation decision in conjunction with management and the board of directors of the issuing company. The level of engagement and control exercised by the issuer varies widely. (Note: in an auction IPO, the investor bids play a much larger role in determining pricing and allocation, although in many auctions, management may exercise discretion around both price and account allocations if that flexibility was built into the auction process and explained to investors in the S–1.)

Institutional Investors

While having no voice in the actual, final pricing or allocation discussions, the indicated interest levels of the institutions are arguably the only voices that actually matter in the first 90 percent of the pricing and allocation decisions. Just as with any other product, if there are not enough interested buyers for a stock at a certain price, the deal will not be done. Similarly, if institutions indicate little price sensitivity, the price range may be raised. The aggregated, indirect opinions of institutions are more important than the underwriter's direct decisions.

Retail Investors

Just as in other fields ranging from sports (golf, racing of any sort) to factory line production, benchmarks, or in this case pricing, is best set by those who are fully committed in a professional capacity. While there are some dedicated individual investors who do read S–1s and do develop forward financial models, those are the rare exceptions as the majority of individuals buying stocks separately, not in mutual funds, do so periodically rather than on a full time basis. Additionally, historical data suggests that retail investors in the aggregate, tend to be more emotional and less analytical in pricing securities. Therefore, it is generally not appropriate for individual investors to have a voice in determining the price or the initial allocations of IPOs. There are two uncommon exceptions to this statement. First, in cases where a company chooses to conduct an auction IPO, the retail investor has the same voice as an institutional investor on a dollar for dollar basis both in pricing and allocation. The other exception is in the case where individual investors, as opposed to institutions, will buy the majority of the stock offered in the IPO.

Promoting Capital Formation

Being a successful public company is an accomplishment, not an entitlement.

Contrary to recently sighted commentary, IPOs do not create jobs any more than red paint makes cars go faster, although in both cases one could incorrectly interpret those relationships from available data. Successful and well-run companies create sustainable jobs and also often go public. The many premature IPOs of the late 1990s created jobs—that lasted for a very short time period, sometimes measured in months. When those newly public companies failed to deliver results, they folded with dire consequences for their employees, investors and the entire stock market, both at the time and for years afterwards. Only now are markets for initial public offerings recovering from the debacle that ensued when the bar for being a public company was set too low.

If we make it too easy for young companies that are not prepared for the rigors of being public and not yet able to document or, within reason, project future financial results, we will increase the risk and decrease the realized rewards of participating in the IPO market. At that point, rational investors will bypass IPOs altogether in favor of the more favorable risk/reward profile of "seasoned" stocks. As we have clearly seen, once-bitten, twice-shy public investors can turn away from funding new businesses for extended periods. In reducing the slope of path required for a company to go public, we create the potential for much more serious capital market problems in the future.

However, while I believe the market's long-term success depends on having appropriate speed-bumps on the road to a public offering, enabling nonpublic entities to raise money from fully informed-of-the-risks individuals could have a very positive impact on capital formation. Specifically:

Crowdfunding and other early stage capital formation should not have a material negative impact on public markets, assuming investors understand how extremely risky early-stage investing is. If crowdfunding enables the growth of many new businesses, particularly in regions with few traditional venture investors or angel investors, then perhaps our Nation will benefit from even more growing entrepreneurial ventures, geographically dispersed across the entire country, rather than in a few select cities or regions.

The danger of crowdfunding comes in two forms: First, since a crowdfunding effort requires little in terms of documentation or information, it will likely attract individuals looking to take advantage of enthusiastic but uninformed investors. Yet asking very young start-up companies to prepare extensive documentation is unrealistic almost by definition, as many will be no more than an interesting, data-light idea. Therefore, some amount of fraud will be inevitable. Secondly, contributors to a crowd-funded effort who fail to fully process the fact that the vast majority of start-ups do not succeed, and that investors in those companies lose their entire investment, may react poorly (see subprime mortgage crisis) when the inevitable happens. An adverse outcome in early stage investing may lead to reduced participation in public markets and therefore, less capital for successful businesses. Again, I believe that the biggest challenge in creating a successful crowdfunding market can be easily solved by asking participants to acknowledge a clearly written, short explanation of the one major risk, that the investment could quickly lose all of its value.

Appropriateness of Retail Investment in IPOs

As previously discussed, IPOs are very risky investment vehicles as there is no trading track-record and as management teams are mostly new at responding to obligations accepted in return for raising public equity. The odds of a management misstep with negative share price implications are greater for newly public companies. Therefore, the only investors who ought participate heavily in the IPO market are those with significant risk tolerance. As some IPOs do trade up rapidly, it would not be appropriate to deny investors the chance to purchase those stocks, and in a free market, investors of all descriptions should have access to all public securities. However, all investors should have to demonstrate that they understand and will take responsibility for these risks. For most people, the best strategy for participating in the IPO market is via mutual funds, where the investment decisions are made by professional, analytical investors who are paid to thoroughly evaluate new offerings on behalf of aggregated groups of individuals.

Many important investor protections are already in place and should not be rolled back. For instance, audits, equally disseminated information and limits on promotional commentary in the period leading up to the transaction are important to a trustworthy IPO process. While complying with many of these regulations, including the Sarbanes-Oxley Act is challenging, time consuming and expensive, companies unable to meet these obligations are likely not ready to successfully handle the time commitment and expense required to keep public investors appropriately informed about the state and health of the business after the initial public offering. Recent roll backs of some investor protection provisions, including looser marketing restrictions, reduced reporting requirements and the new ability to keep confidential the entirety of conversations with the SEC until no fewer than 21 days before the proposed IPO date, in my opinion do a disservice to investors seeking to educate themselves with factual information, as opposed to opinions, about these potential investments prior to the public offering.

Recommended Modifications

I believe the recently enacted "JOBS" act needs significant modification. Specifically:

- I believe the definition of an "emerging growth company" should be reduced to apply only to those companies that still are in the emerging stage. Once a company has achieved revenue of greater than $250 million, it should have the resources to comply with audit and disclosure requirements in place for other public companies.
- To allow management to cooperate with research analysts during what was formerly a quiet period creates extra burdens on management, disadvantages investment banks still subject to the research restrictions of the 2004 Global Research Settlement, and encourages other banks to produce positively skewed research in an effort to win banking business. No research analyst has incentive or enough data to write a negative report on a company that has no trading price and can not be sold.
- As mentioned at the onset of this testimony, I believe a mandated signature below a one or two sentence acknowledgement of risk could provide an important deterrent for those investors believing that IPO investments are an easy route to quick gains. A cigarette package type warning may reduce disappointment and misunderstanding for those investors who are less familiar with the uncertainty of the market for new issues.

Thank you for your time and for the opportunity to testify in front of this Subcommittee.

PREPARED STATEMENT OF JOEL H. TROTTER

PARTNER, LATHAM & WATKINS LLP

JUNE 20, 2012

Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, thank you for inviting me to appear before you today. I appreciate all of the hard work that each of you and the members of your staff give in service of our Nation.

Benefits of a Favorable IPO Environment

I have been a securities lawyer for 17 years, and it's fair to say that initial public offerings (IPOs) have been at the core of my practice for nearly all of my career. In the last 5 years, for example, I have worked on most of the IPOs (approximately 110 of them) on which my firm advised. Recently, I had the honor to serve on the IPO Task Force, whose recommendations gave rise to Title I of the recently enacted Jumpstart Our Business Startups Act, which passed Congress with overwhelming bipartisan support. So, I am steeped in the law and lore of IPOs, and that's the perspective I bring to you today.

In my view, the best way to make the IPO process work for ordinary investors is to ensure that IPOs can happen in the first place. It's important to keep in mind that private companies have two alternative paths for providing liquidity to their early-stage investors: they can choose to pursue either an IPO or a sale of the company. Some companies might try both temporarily, using a dual-track process, but ultimately they have to choose one or the other.

An inhospitable IPO environment sends more early-stage companies toward a sale process and away from the IPO alternative. In recent years, overall IPO activity has fallen off dramatically in the United States, and smaller IPOs have all but disappeared. Over the same period, "the prevalence of IPOs versus acquisitions of emerging growth companies has undergone a stunning reversal," as the IPO Task Force noted last October in its report.[1] In the most recent decade, the vast majority of private company liquidity events have occurred by means of a company sale rather than an IPO. In contrast, during the decade prior to that, IPOs easily represented the majority of private company liquidity events.

This trend warrants our attention because IPOs play an important role in job growth:

- from 1980 to 2005, companies less than 5 years old accounted for all net job growth in the United States, according to an IHS Global Insight study;
- 92 percent of job growth occurs after a company's IPO, mostly within the first 5 years post-IPO, according to the same study; and
- companies that went public since 2006 reported an average of 86 percent job growth post-IPO, according to a survey conducted by the IPO Task Force.

Many of today's household-name companies emerged decades ago as fledgling startups. These companies were, by today's standards, small and untested at the time of their IPOs. And yet some of these now-dominant companies have become so large that entire metropolitan regions have built up around them. Around the Nation, these thriving cityscapes of today would look altogether different if those fledgling startups of yesterday had pursued a company sale in an M&A transaction rather than pursuing independent growth by raising capital in an IPO.

So far, so good. A more robust IPO market will help investment capital by providing more liquidity alternatives for early-stage investors. And more IPOs will have a positive effect on innovation and job creation. How, then, can we help the IPO process?

IPO On-Ramp (Title I of the JOBS Act)

The JOBS Act is an important step in helping the IPO process work better. Title I of the JOBS Act contains the IPO on-ramp provisions implementing the recommendations of the IPO Task Force. These provisions make several important changes to the IPO process for companies that qualify as emerging growth companies. For these companies, Title I of the JOBS Act:

- makes it easier to go public and provides significant cost savings in the IPO process;
- permits them to engage in pre-IPO discussions to gauge investor interest before committing resources to undertake a costly IPO process;
- enables them to begin the SEC registration process confidentially, rather than revealing their most sensitive proprietary information many months before a possible IPO that ultimately may not even occur;
- permits emerging growth companies to present streamlined financial statements using an approach that the SEC previously adopted for smaller reporting companies; and
- provides a limited transitional period of 1 to 5 years, depending on the size of the company, when they may defer compliance with the more costly regulatory requirements that apply to public companies.

Based on a survey of CEOs of pre- and post-IPO companies, the IPO Task Force estimated that going public costs approximately $2.5 million and that remaining public costs approximately $1.5 million annually. Based on survey data and interviews, we estimated that the accommodations in the IPO on-ramp could save companies 30 to 50 percent of those costs.

The accommodations in Title I of the JOBS Act apply to any issuer that qualifies as an "emerging growth company" under the statute. An emerging growth company is an issuer with less than $1 billion in annual revenue for its most recently completed fiscal year. A company will cease to qualify as an emerging growth company in 1 to 5 years, depending on the size of the company. Specifically, emerging growth company status terminates upon the earliest of four milestones:

- the company becomes a "large accelerated filer" under the existing SEC definition (requiring a public float of $700 million at the end of its second fiscal quarter, twelve months of SEC registration and at least one annual report on file);
- the company ends a fiscal year with $1 billion or more in revenue;

[1] IPO Task Force, "Rebuilding the IPO On-Ramp: Putting Emerging Growth Companies and the Job Market Back".

- the company issues more than $1 billion in nonconvertible debt securities over any 3-year period; and
- the fiscal year-end after the fifth anniversary of the IPO pricing date.

With this definition in mind, I will summarize some of the principal accommodations that the IPO on-ramp provides to emerging growth companies:

(1) *Testing the waters*—Section 105(c) of the JOBS Act permits emerging growth companies to engage in pre-IPO discussions with institutional investors to determine whether the company has a good chance of completing a successful offering. Before the JOBS Act, prior restrictions prevented issuers from communicating with potential investors in advance of filing a registration statement. Now, emerging growth companies may engage in discussions to test the waters with institutional investors before deciding whether to commit the time, effort and resources necessary to pursue an IPO process. In the interest of investor protection, the JOBS Act requires companies using this process to deliver a copy of the statutory prospectus to each investor in the IPO before anyone can purchase shares in the offering.

By permitting emerging growth companies to test the waters, the JOBS Act fixes what some practitioners might call a "glitch" under prior law. Before the JOBS Act, a company engaging in a private placement to accredited investors could make an unlimited number of offers, to dozens or even hundreds of prospective investors, and ultimately sell the securities without ever providing those investors with any statutory disclosure. In contrast, the communications restrictions in the IPO process before the JOBS Act were much more restrictive in how issuers could communicate with investors—so restrictive, in fact, that many companies would have difficulty determining whether they could expect sufficient investor interest to complete a successful IPO. This result was not only oddly incongruous but tended to stifle capital formation by inhibiting companies contemplating an IPO. On the one hand, the company could make an unlimited number of offers in an unregulated private placement to accredited investors with no prescribed disclosure. On the other hand, in the heavily regulated context of an IPO, an issuer previously could not have engaged in any pre-filing offers of any kind, even to super-heavyweight institutional investors.[2] The JOBS Act fixes that by permitting emerging growth companies to test the waters with institutional investors so that an emerging growth company can better determine the actual feasibility of an IPO before embarking on the process.

(2) *Confidential submission*—Section 106(a) of the JOBS Act enables emerging growth companies to begin SEC registration on a confidential basis. This follows the SEC's historical accommodation accorded to foreign private issuers and, for emerging growth companies, represents a meaningful change by removing a powerful disincentive for an emerging growth company to pursue an IPO process. Now, an issuer that is an emerging growth company may begin the months-long SEC registration process while deferring until later in the IPO process competitors' access to proprietary business and financial information of the issuer. Companies using this alternative can now advance to the point where they have a much better ability to predict, based on market conditions and other vagaries of attempting to go public, whether they can complete a successful IPO before publicly disclosing their confidential information. In the interest of investor protection, emerging growth companies must publicly file their original confidential submission to the SEC, plus all amendments resulting from the confidential SEC review, at least 21 days before conducting a traditional road show process for the offering. As a result—unlike in the SEC's confidential process historically accorded to foreign private issuers—investors and other interested parties will have immediate Web-based access to the complete submission and amendment history, including the initial draft of the registration statement and each iteration in the nonpublic review process, approximately 1 month before the issuer sells a single share to any investor in the IPO.

(3) *Financial statements*—Section 102(b) of the JOBS Act allows emerging growth companies to present 2 years, rather than 3 years, of audited financial statements in their IPO registration statement. This accommodation follows the framework that the SEC adopted for smaller reporting companies, subject to a 3-year transition to the traditional approach post-IPO. In each future year after the IPO, an emerging growth company that used the accommodation for financial statements would add one additional year so that, after 3 years, the emerging growth company would

[2] Securities Act Rule 163 allows well-known seasoned issuers to make pre-filing offers, but that rule does not apply to IPO issuers and, in any event, contains its own so-called "glitch" that restricts issuers from enlisting their bankers' assistance to test the waters with prospective investors. Securities Act Rule 163(c); cf. Release No. 33-9098 (proposing to correct the glitch in Rule 163(c) by allowing well-known seasoned issuers to use underwriters to help "assess the level of investor interest in their securities before filing a registration statement").

present 3 years of audited financial statements plus 2 years of selected financial data. By using the smaller reporting company framework available under existing law, this provision of the JOBS Act reflects the balance between capital formation and investor protection that the SEC previously struck when it adopted the scaled disclosure requirements that apply to smaller reporting companies.

(4) *On-ramp transition period*—Title I of the JOBS Act provides a regulatory transitional period of 1 to 5 years, depending on the size of the company, when emerging growth companies may defer the more costly requirements that apply to public companies. Like other provisions of Title I, the transition period builds on existing SEC requirements. Under prior SEC rules, for example, all newly public companies, regardless of their size, benefited from a transition period of up to 2 years (until their second post-IPO annual report) before needing an outside audit of their internal controls under Section 404(b) of the Sarbanes-Oxley Act. Title I of the JOBS Act builds on this on-ramp concept by adding additional accommodations to the on-ramp period and by scaling the requirements to the size of the affected company rather than using a one-size-fits-all approach that would treat all companies the same regardless of their size.

IPO On-Ramp Elements

The on-ramp transition period applies as long as the issuer qualifies as an emerging growth company. Smaller companies will have more time to achieve full compliance, while larger companies will have less time. In any event, the transition period would conclude no later than the fiscal year-end after the fifth anniversary of an emerging growth company's IPO. At that point, the company must fully comply with the traditional regulatory requirements that apply broadly to all public companies.

During the transition period, an emerging growth company may:

- defer the outside audit of internal control as required under Section 404(b); [3]
- follow streamlined executive compensation disclosure modeled on existing requirements under the SEC's smaller reporting company rules (which, though streamlined, still require "clear, concise, and understandable disclosure of all . . . compensation" of the top executives); [4]
- defer compliance with the Dodd-Frank executive compensation requirements to hold shareholder advisory votes (say-on-pay, say-on-pay-frequency, and say-on-golden-parachutes) as well as additional compensation disclosure requirements (the pay-for-performance graph and CEO pay ratio disclosure); [5]
- defer compliance with new or revised financial accounting standards until those standards also apply to private companies; [6] and
- benefit from an exemption from any future rules of the Public Company Accounting Oversight Board mandating audit firm rotation or an expanded narrative audit report, called auditor discussion and analysis. [7]

Disclosure vs. Merit Regulation

As you can see, I believe that the JOBS Act's measured reforms will help the IPO process. But is the JOBS Act enough? Are additional changes warranted?

In addressing these questions, I believe it is important to remember how the Congress approached the issue of securities regulation almost 80 years ago when it enacted the Securities Act of 1933. Congress made disclosure the bedrock of our securities regulatory system. But Congress took a very specific approach to disclosure—one that has remained a key feature of our securities laws. In particular, Congress

[3] JOBS Act §103.

[4] JOBS Act §102(c).

[5] JOBS Act §102(a).

[6] JOBS Act §102(b). On occasion, new or revised accounting standards provide private companies with more lead time for compliance than public companies receive. This can occur with more complex standards that require significant data gathering or additional compliance personnel. In those cases, emerging growth companies may follow the longer, private company phase-in period. Alternatively, emerging growth companies may irrevocably elect to follow the shorter phase-in periods that apply to all other public companies. JOBS Act §107(b).

[7] The PCAOB recently issued controversial concept releases on the subjects of whether the PCAOB should mandate audit firm rotation and an expanded narrative, called auditor discussion and analysis, that would appear as part of any financial statement audit. If the PCAOB decides to adopt rules regarding either of these requirements, EGCs will be exempt from those rules. In addition, no other new rule that the PCAOB may adopt in the future will apply to an EGC unless the SEC determines that the new PCAOB rule is "necessary or appropriate in the public interest," after considering investor protection and "whether the action will promote efficiency, competition and capital formation."

has sought to mandate disclosure of material information rather than attempting to pass on the merits of particular securities.

We find this approach reflected in the history and the text of the Securities Act:

- President Roosevelt specifically called for a disclosure regime rather than merit regulation: "The Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn a profit." Instead, Roosevelt envisioned that "every issue of new securities . . . shall be accompanied by full publicity and information." [8]
- Felix Frankfurter, one of the architects of the Securities Act, explained that "Unlike the theory on which State blue sky laws are based, the Federal Securities Act does not place the Government's imprimatur upon securities." The Securities Act, he said, is "designed merely to secure essential facts for the investor, not to substitute the Government's judgment for his own." [9]
- The preamble of the Securities Act specifically reflects this approach, stating that the statute's purpose is to provide "full and fair disclosure of the character of securities."
- Merit regulation focuses principally on investor protection, whereas a disclosure-based approach balances investor protection and capital formation. Section 2(b) of the Securities Act reflects that balanced approach by requiring the SEC, whenever the agency considers whether rulemaking activity is "necessary or appropriate in the public interest," to consider, "in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."

My mentor and former partner, John Huber, previously served as Director of the Division of Corporation Finance at the SEC. He used a memorable anecdote to teach me the difference between merit regulation and a disclosure regime. Early in his career, John worked at a State securities commission. Staffers at the commission were proud of having refused to approve the common stock of a company whose name everyone in this room would recognize. The State securities commission had objected to the level of the CEO's compensation and therefore refused to permit the company to sell its stock to residents of that State. "What was the IPO price?" John asked. Answer: $22 per share. "Well," he responded, "the stock is now trading at $60 per share, so how exactly did we help investors in our State by preventing them from buying at $22?"

Disclosure in the IPO Process

That nicely sums up merit regulation. We can see why Felix Frankfurter emphasized that the Securities Act would merely "secure essential facts for the investor" rather than placing the Government in the position of making investment decisions. This brings us to another issue: what are the essential facts for the investor?

Again, I return to core principles of our securities laws. We require disclosure of all information that is "material."

The Federal securities laws contain a matrix of antifraud provisions designed to promote accurate and complete disclosure by imposing liability on material misstatements or omissions in connection with the purchase or sale of a security. In the landmark case of *TSC Industries v. Northway,* a unanimous Supreme Court established the fundamental test of materiality. The Court held that a fact is material if there is a substantial likelihood that a reasonable investor would consider the fact important in deciding whether or not purchase or sell a security. Moreover, the Supreme Court explained, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information available." [10]

If you have picked up an IPO prospectus recently, you may wonder whether we have drifted very far from the guiding principle of disclosing material information. An IPO prospectus today is a lengthy and detailed disclosure document often running as much as 200 or more pages in which the issuer provides:

- detailed narrative descriptions of the business, the company's executive management team and board of directors;
- risk factors identifying key risks relating to the company and the offering;

[8] H.R. Rep. No. 85, 73d Cong., 1st Sess. at 1-2 (1933).
[9] Felix Frankfurter, "The Federal Securities Act: II", *Fortune* (Aug. 1933).
[10] *TSC Industries v. Northway,* 426 U.S. 438, 449 (1976).

- audited financial statements and footnotes;
- MD&A disclosure providing a narrative description of management's perspective on the financial statements, including known trends and uncertainties (together with the financial statements, this narrative usually occupies almost half of the page count in the prospectus); and
- detailed disclosures on many other topics, including executive compensation, related party transactions, principal stockholders, description of the offered securities, underwriting arrangements, and other types of details required under SEC rules.

All of these are good and useful topics. But it can be hard to resist the temptation to add just a few more sentences here and a paragraph or two there, with the end result that the disclosure becomes impressive for its heft rather than for being clear and insightful. Brevity may be the soul of wit, but it is rarely the hallmark of an IPO prospectus.

The SEC's Advisory Committee on Improvements to Financial Reporting recognized this problem when it identified an "overly broad application of the concept of materiality and misinterpretations of the existing guidance regarding materiality."[11] Or, in the words of a unanimous Supreme Court, "Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good." An unduly low materiality standard, warned the Court, will bury investors in an avalanche of trivia:

> If the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision making.[12]

A balanced and reasonable approach to materiality is critical to the success of a disclosure-based regulatory regime. To be sure, our modern securities markets have changed in ways that would have seemed inconceivable to President Roosevelt and the Members of the 73rd Congress who enacted the Securities Act of 1933. But I respectfully submit that a fundamental principle that guided them has served our Nation well for the last eight decades of securities regulation—disclosure of the "essential facts for the investor," focusing on what is truly material information. That principle continues to serve individual investors best, even as the nature of the securities markets changes.

Risk and Reward

I would like to conclude with one additional thought. It is a fact of economic life that not all IPOs succeed. Any commercial enterprise that can earn a profit can also earn a loss. That's part of the tradeoff between risk and reward. IPO stocks can be very rewarding over the long term, but that necessitates investment risk, and that in turn brings the possibility of loss.

In other words, IPOs are potentially rewarding investments that carry corresponding risk. Like any business, a newly public company may or may not make money for its investors. That is why the cover page of every IPO prospectus says, "This is our initial public offering, and no public market currently exists for our common stock." That is why every IPO prospectus contains many pages of detailed risk factors regarding the company and the offering.

SEC Commissioner Daniel Gallagher recently underscored the need for capital markets that offer both transparency and the opportunity to put investment capital at risk:

> When we consider proposed regulation, and the economic policy context in which we operate, we must think increasingly consciously not only of the protections we hope to give investors, but of the incentives and disincentives we create for capital formation itself in our public markets. Fair, transparent, and deep capital markets are good. Risk-free capital markets have no future. Were we somehow to create one, it wouldn't offer oppor-

[11] Final Report of the Advisory Committee on Improvements to Financial Reporting (Aug. 1, 2008), at 76.
[12] TSC Industries, 426 U.S. at 448–449.

tunity enough to attract either companies to list or investors, who would do just as well in savings accounts or Treasury bills.[13]

Thank you. It has been a pleasure to be here with you this morning. For reasons I hope you understand, I cannot discuss any specific IPOs and am unable to comment on any proposed regulatory changes. Otherwise, I welcome any questions you may have.

PREPARED STATEMENT OF ILAN MOSCOVITZ

SENIOR ANALYST, THE MOTLEY FOOL

JUNE 20, 2012

Mr. Chairman and Members of the Committee: I want to thank you for the opportunity to offer testimony and recommendations today. My name is Ilan Moscovitz, senior analyst for The Motley Fool.

Founded in 1993, The Motley Fool's purpose is to help the world invest better. To that end, we have created the world's largest investment community for individual investors to learn, share, and grow together.

Millions of investors rely on The Motley Fool not only for guidance on how to manage their money, but also as an advocate for their rights as shareholders. For years we have worked to create a level playing field in the market. It's for this reason that we are eager and grateful to discuss whether the IPO process is working for ordinary investors.

It goes without saying that IPOs are critical to both developing public markets and helping businesses raise the capital they need to grow and hire.

Public markets give ordinary investors the opportunity to participate in the growth and success of companies. They also increase transparency and accountability, making our economy more efficient and competitive.

However, in a world of finite capital, we need to recognize that there are good IPOs, and there are bad IPOs. On the one hand you have Apple, Microsoft, and Starbucks, all of which went on to successfully innovate their industries as public companies. And on the other, you have Pets.com, a retailer with an unproven business model that was losing money on every sale, and which filed for bankruptcy less than a year after going public, taking with it the $82 million that it raised from public investors.[1] Needless to say, a properly functioning market gives capital to good companies and not bad ones.

The quality of IPOs is just as important as their quantity.

From our vantage point as retail investors, the overarching problem with IPOs is that there is an imbalance of both information and access. Although issuers and venture capitalists ultimately depend on us for capital and liquidity, the deck is stacked against us in at least two major ways.

First, insiders, underwriters, and their favored clients have access to more and better information than do ordinary investors. This gives them an unfair advantage over us in estimating a company's fair value. Reports of Facebook's recent IPO provide a prominent example of this,[2] and improved efficiency in IPO pricing when information is freely available provides a statistical illustration of the problem.[3]

Second, there's unequal access to shares. The initial offering is traditionally limited to preferred clients of underwriters. By the time we can buy shares, there's already been a significant markup. It's estimated that from 1990 to 2009, that markup averaged 22 percent, totaling $124 billion.[4]

In addition to these two problems, the fact that IPOs are weighted against individual investors needlessly diminishes confidence in our markets.

Consider the chart below.[5] After a period of artificially inflated volume of IPOs in the mid-to-late 1990s, filings dropped by 75 percent from 2000–2001 once retail investors lost confidence in the quality of companies coming public.

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[13] Daniel M. Gallagher, "Remarks Before AusBiotech" (May 1, 2012).

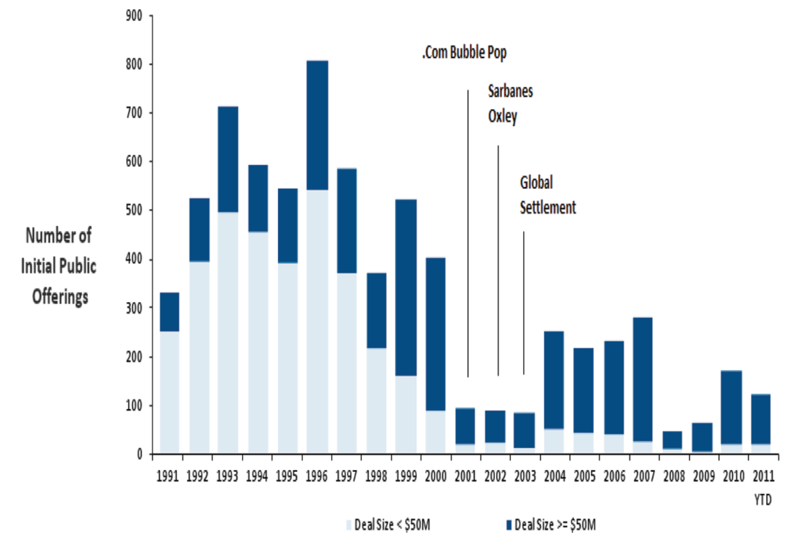
[1] Pets.com was a retailer with negative gross margins. *See,* Pets.com, S–1 Filing.

[2] *See,* Olivia Oran and Nadia Damouni, "Facebook Advised Analysts To Cut Forecasts Before Float", Reuters.

[3] Steven Davidoff, "Why I.P.O.'s Get Underpriced", *New York Times Dealbook.*

[4] Jay Ritter, "Mean First-day Returns and Money Left on the Table, 1990–2009".

[5] IPO Task Force, "Rebuilding the IPO On-Ramp".



Sources: JMP Securities, Dealogic, Capital Markets Advisory Partners, Grant Thornton

Fast-forward to today, and we're on track to have the fewest number of June IPO filings since 2003 (excluding the financial crisis)[6] in the aftermath of Groupon's questionable accounting and reports that Facebook's underwriters disclosed material information to favored clients and not to the rest of us.

As a side note, it's worth pointing out that the number of IPO filings had doubled after the global settlement and passage of Sarbanes-Oxley addressed some of the worst abuses of the dot-com bubble and ensuing years.

Unfortunately, the recently passed JOBS Act undoes many of these reforms for most companies coming public, and provisions that weaken reporting requirements will result in less information reaching investors. The dramatic collapse of confidence in Chinese emerging-growth companies in 2010 that followed reports of accounting problems[7] is another recent example of how reducing the quality of reporting can ruin investors' faith in all emerging growth companies. In just 1 year, shares of 93 percent of Chinese emerging-growth companies fell, cutting the average market value of Chinese emerging-growth companies in half, costing public investors $11 billion, and harming the ability of any good emerging-growth companies to raise capital.[8]

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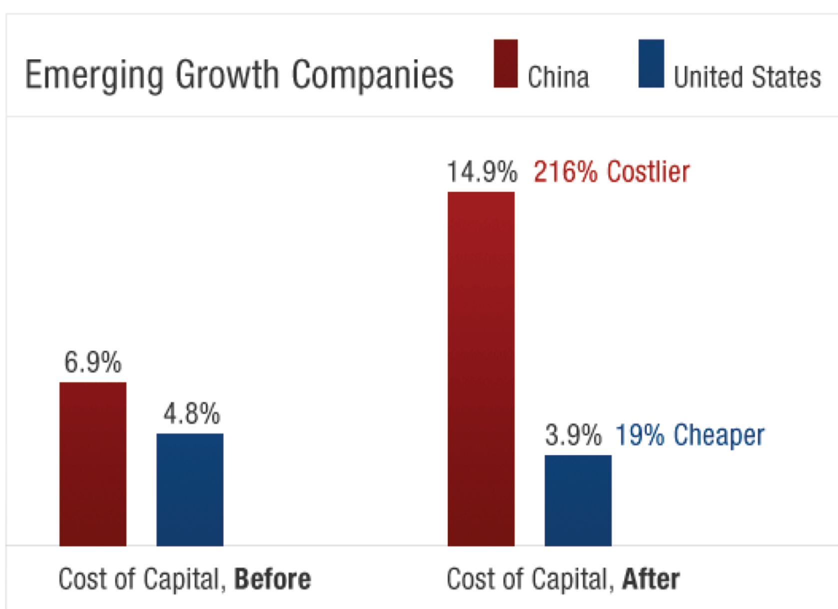
[6] Renaissance Capital IPO Home, "U.S. IPO Filings".

[7] *See,* Bill Alpert and Leslie Norton, "Beware This Chinese Export", Barron's, and Muddy Waters, "Muddy Waters Initiating Coverage on RINO—Strong Sell".

[8] Data from S&P Capital IQ. "Cost of Capital" here refers to a company's earnings yield.


1-Year Stock Return, August 2010
16% Dow Jones Industrial Index
2% Xinhua Chinese 25 Index
7% U.S. Emerging Growth Companies
(48%) Chinese Emerging Growth Companies


Emerging Growth Companies
China
United States
14.9%
216% Costlier
6.9%
4.8%
3.9%
19% Cheaper
Cost of Capital, Before
Cost of Capital, After

This isn't to suggest that weakening the quality of American accounting to be more closely aligned with China's will necessarily cause an equivalent increase in the cost of capital for American EGCs, but it's not the direction we want to move in.

To remedy these problems, our objective should be to level the playing field and pre-empt such crises of legitimacy by maximizing transparency and useful disclosure in the marketplace.

Here are three recommendations:

1. Extend the application and enforcement of Regulation Fair Disclosure to the beginning of the IPO process. This will help to improve the flow of information to all investors and reduce one of the most preventable information asymmetries—between underwriters and their favored clients, and ordinary investors.
2. Second, require that companies and underwriters allocate shares in the initial offering in a more inclusive and efficient manner. Over the past decade, companies like Google, Morningstar, and Interactive Brokers have successfully employed a Dutch auction process, which gives all investors the opportunity to buy shares at the same price, under an equitable plan of distribution. An ancillary benefit is to lower the cost of going public for companies by more than half.[9]
3. Finally, fix the most troubling portions of the JOBS Act from the retail investor's perspective. While there are a number of improvements that could be made, if you're looking for the most straightforward remedies, one would be to decrease the size threshold in the emerging-growth company definition, as the Chairman has previously recommended, to increase the amount of information available to investors. After all, the current definition encompasses virtually all IPOs, and companies larger than, say, $350 million in gross revenues really are large enough to provide 3 years of audited financial statements.[10]

A second remedy would be to implement a lockup period covering pre-IPO insiders in emerging-growth companies. The period should include the offering and extend for at least 180 days after an issuer is subject to normal reporting requirements, which has been common practice prior to passage of the JOBS Act. This will better align the incentives of insiders and ordinary investors. It will also help to ensure that any capital raised via the emerging-growth-company exemption serves its intended purpose by flowing to the company and not to insiders exiting on the IPO on-ramp.

As the IPO process currently stands, ordinary investors have unequal access to information and unequal access to the market. We are asking for a level playing field, disclosure, and transparency. We believe the lack of these qualities is what's most troubling about the IPO process right now.

I appreciate the opportunity to submit testimony on how IPOs affect ordinary investors and would be happy to answer any questions.

[9] Jason Zweig, "The Demise of the IPO—And Ideas for How To Revive It", *Wall Street Journal.*

[10] Data from S&P Capital IQ in Ilan Moscovitz, "4 Scary Things About the JOBS Act", Fool.com.