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Capital Formation, Job Creation and Congress: Private Versus Public Markets

by John C. Coffee, Jr.*

Over the last few weeks, the House of Representatives has passed three bills, in each case by an over 400 vote margin, that create new exemptions under the Securities Act of 1933 in the hopes of fostering job creation. Other legislation may soon also pass the House that raises the level at which an issuer must become a "reporting" company under Section 12(g) of the Securities Exchange Act of 1934 to 1,000 shareholders of record (and also excludes certain shareholders from this computation). Today, one suspects that a bill permitting the dumping of toxic waste into rivers and harbors or decriminalizing insider trading would have a fair chance of passage – if it were captioned the "Job Creation Act of 2011."

But will these new exemptions really be used? If not, they will hardly create jobs. This column will agree that there is a problem of access today in our equity capital markets: smaller issuers cannot do initial public offerings (or "IPOs") for a variety of reasons. As a result, they rely on private placements. This may or may not be efficient (as private equity market may inherently provide cheaper access to equity capital for smaller companies). This decade long shift to private equity financing as a substitute for smaller public offerings probably has a variety of causes, including the gradual liberalization of Rule 144, changes in market structure that reduce the willingness of brokers and investment banks to support research by securities analysts, and the appearance of a private equity secondary market. Together, these problems mitigate the traditional

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problem of illiquidity associated with private placements and may often make them a more attractive alternative to a risky and costly smaller public offering.

As a result, even if these proposed exemptions are enacted, it is not clear that they will be extensively used. In “Field of Dreams,” a voice said “Build it, and they will come.” That may be true in baseball, but it does not necessarily work in the case of securities markets.

A. <u>The Vanishing Small IPO</u>

Small initial public offerings – defined for this purpose as those raising less than $50 million – have declined dramatically. From 1991 to 1997, nearly 80% of U.S. IPOs were below the $50 million threshold.[1] But, by 2000, their share had declined to 20% (or less) of all IPOs, and in 2009 and 2010, IPOs of under $50 million appear to have constituted only around 17% and 18%, respectively, of the number of all IPOs. Because some prominent high tech companies – Intel, Amgen, Oracle, Cisco, Starbucks and Yahoo – did IPOs of under $50 million, an understandable concern arises that the disappearance of small IPOs implies that the U.S. is today unable to provide equity finance to precisely the smaller companies that historically have fueled job creation.

In the supercharged political environment of Washington in an election year, this possibility that the federal securities laws are somehow responsible for a lack of equity financing for smaller companies (and hence for possible job loss) has produced a flurry of legislation. The implicit premise of these bills is that overregulation is responsible for job loss. In particular, many in both parties want to blame the decline in smaller IPOs on the Sarbanes-Oxley Act of 2002 (“SOX”). Politically attractive as this theory is to some, the facts do not support it. A precipitous drop in the number of below $50 million IPOs occurred between 1998-2000, and there has been little significant change since that point. Because this decline preceded SOX by several years, it is difficult to insist that SOX was its cause (unless you are running for office). Further, even if one wanted to blame the continued absence of small IPOs on SOX, there is an additional problem: both the SEC and Congress have exempted issuers with a market capitalization under $75 million from SOX's Section 404 (which became that Act's most costly provision after it was interpreted to require an annual audit of the issuer's internal controls over financial reporting).[2] Logic, however, may be a fairly weak force when it comes to restraining Congress, and thus, under some recent proposals, Section 404 would be suspended for all companies with a market capitalization of under $1 billion.[3]

Suppose, however, that we wanted to really understand what has caused the decline in smaller IPOs. What factors could explain it? Several arguments seem capable of accounting for much of this decline: First, small IPOs have high fixed costs that make them an inefficient way to raise capital. These costs grew in the 1990s and created a sharp disparity between the costs of a public offering and a private placement. Second, changes in market structure have greatly reduced both spreads and brokerage commissions and, as a result, have made the financial services industry less willing to invest in securities research or support securities analysts. Without such support, smaller IPOs are particularly vulnerable. Third, institutional investors disfavor smaller IPOs, because they want high liquidity. The level of liquidity that they desire probably begins somewhere around a market capitalization level of $500 million or more; hence, smaller IPOs cannot be marketed to institutions, and the principal underwriters are not geared to marketing IPO offerings to retail investors. Finally, and possibly most importantly, the liberalization of Rule 144 in the 1990s and the reduction of its holding period from two years to one year in 1997 increased the attractiveness of private placements by reducing the mandatory period of illiquidity.[4] Add to this the recent appearance of an active secondary market in "restricted securities," and the need to do an IPO became less pressing for insiders who have gained greater liquidity.

Let's start with the high fixed cost argument. Because IPOs face high liability under Sections 11 and 12(a)(2) of the Securities Act of 1933, greater legal and auditing expenses must be incurred by the issuer, both in preparing a far more elaborate disclosure document (i.e., the registration statement) and in conducting some requisite due diligence. Much less work and expense is required if the same issuer instead raises the same capital by means of a private placement. Other additional expenses must also be incurred to continue as a public company: i.e., listing fees, D&O insurance, enhanced auditing requirements, the costs of periodic reporting, shareholder relations, etc. None of these expenses are necessary (or at least as high) if the issuer remains a private company.

Are the costs of an IPO particularly high in the U.S.? One global comparative study of the IPO offering process across different exchanges, covering the period from 1999 to 2007, finds that the average aggregate IPO flotation cost, as a percentage of the offering proceeds, varied as follows: Euronext (7.6%); NYSE (7.7%); Deutsche Borse (8.3%); Nasdaq (9.5%); LSE (12.6%); Hong Kong Stock Exchange (14.6%).[5] On this basis, the U.S. does not look comparatively high, and the difference between 7.7% on the NYSE and 9.5% on Nasdaq probably reflects the characteristically larger size of NYSE IPOs in comparison to those on Nasdaq. The same study finds that for small cap IPOs, the aggregate flotation costs were 10.1% on both the NYSE and Nasdaq.[6]

A more revealing picture of IPO costs emerges if we break down IPO flotation costs into two components: (1) underwriting costs, and (2) non-underwriting costs (i.e., legal auditing and similar professional costs). On a comparative basis, the U.S. does not look particularly costly with respect to the non-underwriting fees. Those non-underwriting fees in the same study were 1.2% on the NYSE, 1.9% on Euronext, 2.1% on Deutsche Borse, 2.6% on Nasdaq, 4.9% on the LSE, and a whopping 10% on the Hong Kong Stock Exchange.[7] The difference between the NYSE and Nasdaq probably again largely reflects a difference in the average size of their typical offering.

But when we look at the comparative differences in underwriting costs for an IPO, the U.S. looks very different. Median underwriting fees were 2.5% on the Hong Kong Stock Exchange, 3.3% on the LSE, 3.6% on Euronext, 4.8% on the Deutsche Borse, 6.5% on the NYSE and 7.0% on Nasdaq.[8] In short, U.S. underwriters charge roughly double what U.K. underwriters appear to charge.

U.S. underwriters may defend their greater fees by arguing that they do more for their clients. Their elaborate "book building" efforts often create an enormous first day "pop" that leads the IPO stock to close on the first day at a substantial premium over the initial offering price. This is fine for the investors fortunate enough to receive an IPO allocation in a "hot" IPO, but if our interest is in "job creation" (which is where Congress now appears to be focused), this justification for high underwriting fees is more part of the problem than part of the answer. Elaborate book building by underwriters (i.e., road shows and the like) to create an overheated demand that can be a high multiple of the stock to be sold is unavoidably expensive. More importantly, the first day "pop" or price run-up that they produce goes to investors, not the IPO company. Indeed, the significant underpricing of IPOs (which has long been the American pattern[9]) actually deprives the IPO company of capital, transferring wealth from it to the institutional investors who receive "hot" IPO allocations. If underpricing of IPOs were discouraged and the issuer were to receive greater value for its shares, job creation might increase.

How could the U.S. regulatory system discourage the underpricing of IPOs and thereby encourage job creation? The most direct means to this end would be to encourage use of the auction method for pricing IPOs, thus ensuring that the IPO issuer would receive a higher price. This is, of course, an academic idea – that is, entirely correct, but too radical to influence public policy. Underwriters and institutional investors would resist it fiercely and Congress will not understand it. Nonetheless, the key point about costs is that the smaller the IPO, the greater the flotation costs as a percentage of the total offering. Road shows just cannot be justified for smaller offerings, and without them one cannot expect a dramatic first day run-up in the stock price. Hence, neither underwriters nor institutional investors view the smaller IPO offering as attractive from a short-term perspective. The fall-off in smaller IPOs occurred in 1997 and 1998 just as the Internet stock bubble also crested in 1998 and 1999, and essentially underwriters could not be bothered with small deals in this exuberant market.

A second basic explanation for why the smaller IPO has declined as a percentage of all IPOs involves changes in market structure.[10] Remember that a sudden drop occurred between 1998-2000 in the percentage that smaller IPOs bore to all IPOs. The SEC's Order Handling Rules were introduced in 1997 in response to the Nasdaq price-fixing scandal (when it was discovered that brokers were not trading on the odd eighths of a point).[11] Regulation ATS was adopted in 1998,[12] and it quickly facilitated the growth of “electronic communication networks” (or “ECNs”). Decimalization followed in 2001. All these developments, plus the prohibition on trade-throughs in Regulation NMS in 2005, narrowed spreads and reduced brokerage commissions. Trading operations became less profitable, and brokerage firms as a result invested less in securities analysts. Finally, Eliot Spitzer’s 2001 investigations of securities analysts led to a global settlement with the major investment banks that imposed an informational partition between investment banking and securities research. While the IPO market became more honest and transparent as a result, underwriters could no longer use their analysts to tout their IPOs. Smaller IPOs in particular may have become harder to market. Thus, one industry group is seriously pushing the idea of returning to the pre-Spitzer era of conflicted securities analysts in order to better market IPOs and arguably encourage job creation.[13] It is as if they are saying: “Bring Back Henry Blodgett and Jack Grubman.” The problem with this line of reasoning is that it ignores that there is a long-term cost to stock bubbles. Many retail investors who were burned when the IPO bubble burst in 2000 have stayed away from IPOs in the interval since then. Investor confidence is at risk if Congress listens to those who want to restore the conflicts of interest that characterized the marketing of IPOs in the late 1990s.

The final barrier to any resurgence of smaller IPOs is that institutions want liquidity, which micro-cap stocks by definition lack. Unlike the earlier discussed problems, this is a “buy side” problem. The only way to address it is to design a system that markets smaller IPOs to smaller investors, who may be more willing to buy and hold for the longer term and are not looking to “flip” the stock in the short-run.

For all these reasons, smaller non-public companies have less expectations today of being able to access the public equity market and are instead relying more on private placements and multiple rounds of venture capital financing. This is not necessarily bad. Because the costs are lower, a private financing may be both quicker and cheaper. Possibly, the smaller company will still hope to do an eventual IPO, but only at the point at which its potential market capitalization will be large enough to interest institutional investors and provide them with the liquidity they desire.

This shift from public markets to private markets is probably cost efficient for most smaller issuers – so long as the smaller company needs only to raise a modest amount. The SEC's Chief Economist has pointed out that there have been some 37,000 offerings under Regulation D since 2009, and the median such offering has been for approximately $1 million.[14] For offerings of this size, none of the proposed new techniques – either an expanded Regulation A or "crowdfunding" – are likely to be as cheap or as easy to consummate as a Regulation D offering.

A potential problem arises, however, if the small issuer needs to raise capital in a larger amount. Here, it is at least arguable that the small issuer will be constrained because of the current bar on any "general solicitation" under Regulation D.[15] Also, some smaller issuers may be inhibited by the "Facebook" problem: these issuers are rapidly approaching the point at which they would have 500 or more shareholders of record at year end and thus be forced to become "reporting" companies under Section 12(g) of the 1934 Act, even though they have not done any public offering. Arguably, it now takes longer for an issuer to mature to the stage where it is an attractive IPO candidate, and stock options expire during this period, requiring them to be exercised. Of course, selfhelp remedies could solve this problem (for example, shares could be owned beneficially by "insider" purchasers as this threshold is neared, possibly with a common broker holding record ownership). Although this practical solution would work, it may be the case that "private" shareholders want to hold the shares in their own name. Such a preference seems slightly implausible, however, as "public" shareholders seem to have no problem with (and see some advantages in) brokers serving as the record owner. The urgency of the need for the increase in the Section 12(g) threshold thus seems suspect.

B. The Proposed Solutions

Three bills have passed the House of Representatives by overwhelming 400 vote margins: (1) H.R. 1070 (which would increase the exemption under Section 3(b) of the Securities Act of 1933 from $5 million to $50 million); (2) H.R. 2930 (the "crowdfunding" bill that would enact a new Section 4(6) to the Securities Act); and (3) H.R. 2940 (which would authorize a "general solicitation" of accredited investors under Rule 506). In addition, H.R. 2167 (which has not yet passed but is gaining momentum) would raise the threshold at which a company must become a "reporting" company under Section 12(g) from 500 shareholders to 1,000 and exclude from this computation employee/shareholders who received their shares under employee benefit plans or similar compensation arrangements. Each merits a brief review.

1. H.R. 1070 (the "Small Company Capital formation Act of 2011"). This is the best crafted of the pending bills, and it passed the House by a vote of 421 to 1 (reputedly with only Congressman Dingell of Michigan voting nay). The real question is whether it will be used. Essentially, the bill raises the ceiling on the exemption in Section 3(b) of the Securities Act from $5 million to $50 million in any 12-month period. The securities so

sold would not become “restricted securities” and could be resold immediately. The issuer could engage in a general solicitation, but it and any persons selling on its behalf would be expressly subject to liability under Section 12(a)(2) of the Securities Act. The issuer would have to both prepare an offering statement, containing audited financial statements, and to file such periodic disclosures as the Commission decided by rule to require. The bottom line is that this would likely resemble a slightly enhanced Regulation A offering.

As a practical matter, Regulation A has been trivialized by its $5 million ceiling, and in 2010, only seven Regulation A offerings went effective. Because H.R. 1070 contemplates a mandatory disclosure document, which would be reviewed by the SEC and backstopped by Section 12(a)(2)’s negligence-based liability, it is hard to fault this provision on investor protection grounds

But what would be its real impact? I suggest that the real world impact of moving the Section 3(b) ceiling from $5 million to $50 million is that it would eventually compel the SEC to similarly raise the ceiling on Rule 505 under Regulation D from $5 million to $50 million. Rules 504 and 505 of Regulation D are essentially predicated on Section 3(b), and not Section 4(2) (on which foundation Rule 506 alone rests). Thus, sooner or later (and probably sooner), the SEC would be pressured to move the ceilings up on both Rules 504 and 505 to $5 and $50 million, respectively. What would this mean? In the case of Rule 505, an issuer would be able to sell up to $50 million to unsophisticated investors, subject to a 35 purchaser limitation, in any 12-month period. In the case of Rule 504, the ceiling might logically move to $5 million, with no disclosure document being required. General solicitation would still be precluded (unless, as is the case under rule 504 today, some disclosure document was distributed).[16]

Which option would issuers prefer – Rule 505 for $50 million or Regulation A for $50 million? There would be less liability under Rule 505 (because Section 12(a)(2) does not apply to private offerings),[17] and there would be no SEC review (which the recent Groupon offering shows can make life uncomfortable for issuers with novel accounting). Conversely, the 35 purchaser limitation in Rule 505 (unless relaxed) might materially constrain issuers seeking to raise $50 million in a private offering. My own evaluation is that most issuers would prefer relying on a private offering under Rule 505, unless the disclosure requirements under the new Regulation A offering were greatly streamlined.

2. H.R. 2930 ("Entrepreneur Access to Capital Act"). Unlike H.R. 1070, this bill introduces a genuinely novel and genuinely ill-considered idea: "crowdfunding."[18] Essentially, a new Section 4(6) of the Securities Act would authorize the public sale of securities without a disclosure document or SEC review to unsophisticated retail investors. Under H.R. 1070, the issuer could only sell $1 million in aggregate amount in any 12 month period (or $2,000,000 if it provided audited financial statements). It would be required to warn investors of "the speculative risks generally applicable to startups, emerging businesses and small issuers," but no disclosure document is mandated. The one substantive restriction on this exemption would be that no investor could purchase more than the lesser of $10,000 or 10% of his annual income on securities of any one issuer annually, and the investor could not resell (except to the issuer or an accredited investor) for a one year period.

What would be the impact? Because this provision expressly provides that securities could be sold by intermediaries who were not registered brokers-dealers, every barroom in America might come to be populated by a character, looking something like Danny DeVito, obnoxiously trying to sell securities to his fellow patrons. He could provide each fellow patron with a business card that noted that the securities carried high risk, but would need to provide no other disclosure.

How attractive is this proposed exemption for issuers? One million dollars is a low ceiling, and Rule 504 already permits a similar level of sales to unsophisticated retail investors. The only difference is that under Rule 504, an issuer cannot make a general solicitation without providing a disclosure document that satisfies state "Blue Sky" law requirements. Under proposed Section 4(6), state law would be preempted (and the retail shareholders who acquire these securities would not count towards the Section 12(g) threshold for "reporting" company status). Possibly, this provision would be used by some small companies because it freely permits general solicitation, but a ceiling set at the lesser of $10,000 or 10% of annual income is confining, and would in my judgment make most fly-by-night issuers still prefer Rule 504.

3. H.R. 2040 ("Access to Capital for Job Creators Act"). This bill, which passed the House by a 413 to 11 vote, would permit general solicitation and general advertising in the case of offers or sales made under Rule 506 to accredited investors. That concept is understandable, but the drafting is inelegant, because it amends Section 4(2) of the Securities Act by adding at its end before the period: ", whether or not such transactions involve general solicitation or general advertising." This would seemingly imply that a general solicitation was permissible under this statutory language even in offerings made

to sophisticated persons who were not accredited investors. Although the SEC might not read it in this fashion, the D.C. Circuit or the Supreme Court could easily find that the plain meaning of Section 4(2), as so revised, was to permit the general solicitation of any person, not just accredited investors, who qualified as a purchaser under Section 4(2).

4. H.R. 2167 (the "Private Company Flexibility and Growth Act"). Although this bill has not yet passed the House, it has both substantial support and substantial opposition, because it could broadly reduce transparency in the secondary market. Essentially, it would raise the Section 12(g) threshold for registration as a "reporting" company from 500 shareholders of record to 1,000, and it would exclude persons from this computation who "received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of Section 5 of the Securities Act of 1933." This latter provision is implicitly referring to Rule 701,[19] which dispenses with registration for stock sold under such plans on the ground that the transaction is more a matter of employee compensation than of investment decision-making. Logically, if disclosure is not required on the sales to the employees, there seems little reasons to use those same sales as a basis for requiring periodic disclosure by the issuer to the market.

But what about the increase from 500 to 1,000 shareholders of record? Here, the problem is that this standard is already seriously underinclusive in a world where most shareholders hold their securities in street name. Raising the limit to 1,000 invites gaming, as companies with a large market capitalization might still avoid the SEC's periodic disclosure system by convincing most of their shareholders to hold in street name. This seems undesirable, particularly when smaller companies could legitimately avoid Section 12(g) by also convincing their shareholders to use street name ownership.

What then is the best answer? Probably, the best measure of when a company should because a reporting company is not the number of its shareholders of record, but the size of its "public float": i.e., the market value of the shares held by shareholders who are not affiliates of the issuer. For example, in determining eligibility for Form S-3, the SEC has long used a public float requirement of at least $75 million.[20] In effect, this was the SEC's judgment of where the efficient market began. Correspondingly, Section 12(g) should use a similar standard. In order not to have retroactive effect or to reach large, but truly private, companies (such as those controlled by a single family), a revised threshold might require that an issuer have 500 shareholders of record plus a public float of a specified level (say $75 million). In truth, a $100 million public float would today be politically more acceptable. The problem with a 1,000 shareholder of record standard is that it could exempt even a company with a public float of $1 billion and 2,500 beneficial shareholders.

When an exemption is as overbroad as that proposed by H.R. 2167, one has to ask who is really benefitting from this clumsy a formulation. The answer may be that this exemption primarily serves the interest of the new private equity brokers (such as Second Market). A high ceiling (such as 1,000 shareholders of record) allows them to service not just small companies as they grow, but much larger companies that are discouraging their shareholders from holding record ownership. This does not create jobs, but does allocate economic rents to those seeking such an exemption.

Conclusion

The proposed expansion of Section 3(b) and the proposed authorization of a "general solicitation" in the case of offerings to accredited investors under Rule 506 will not disrupt or undermine the federal securities laws, but there are still serious issues as to whether these exemptions will be used. Private placements may remain cheaper and quicker. The key advantages of the proposed revision to Regulation A are: (1) it will not be subject to a 35 purchaser limit; (2) the purchaser will not acquire "restricted securities"; and (3) a general solicitation can be made. But, because it will subject the issuer to greater liability and SEC oversight, many issuers may stick with a Regulation D offering (particularly if Rules 505 and 504 have their ceilings raised). "Crowdfunding" in contrast offers little, even to the "fly-by-night" issuer, that is not already available under Rule 504.

To sum up: the private markets may be working adequately, and only modest changes seem justified.

<u>Endnotes</u>

[1] Grant Thornton, the accounting firm, has done a series of studies plotting the decline in small IPOs. See Grant Thornton, “Stock Markets, Capital Formation and Job Creation Under Attack” (2011). The share of below $50 million IPOs peaked at just over 80% in 1994, but remained over 75% from 1991 to 1995. For a fuller description, see Statement of David Weild before the U.S. House of Representatives, Financial Services Committee, Capital Markets and Government Sponsored Enterprises Subcommittee, on March 18, 2011.

[2] Section 404 of the Sarbanes-Oxley Act did unquestionably impose high costs on issuers by mandating an annual audit of internal controls over financial reporting. But the relaxation of these requirements began with the adoption of Auditing Standard No. 5 in 2007. See Securities Exchange Act Release No. 34-56152 (July 27, 2007). In addition, Section 989G of the Dodd-Frank Act exempted issuers with a market capitalization of $75 million or less from Section 404. Hence, Section 404’s expensive requirements do not apply to smaller issuers.

[3] The Council on Jobs and Competitiveness, an advisory board to the White House, has proposed such an exemption from Section 404, but the idea has been harshly criticized by some editorial writers, including the New York Times. See “Not Their Job,” New York Times, October 20, 2011 at p. 28.

[4] See Securities Act Release No. 33-7390 (February 20, 1997).

[5] See Prof. Christoph Kaserer and Prof. Dirk Schiereck, “Going Public and Being Public – A Global Comparison of the Impact of the Listing Decision on the Cost of Capital” (2007) at pp. 7-8. Both authors are professors at European business schools.

[6] Id. at pp. 22-23. Smaller offerings in this study meant offerings of under 100 million Euros.

[7] Id. at p. 8.

[8] Id.

[9] Underpricing is a well-recognized feature in U.S. IPOs, and a successful offering will often have a significant first day run-up in stock price. See Tinic, Anatomy of Initial Public Offerings of Common Stock, 43 J. Fin. 789 (1988).

[10] For this view, see David Weild, "How to Revive Small-Cap IPOs," The Wall Street Journal, October 28, 2011 at p. A-17. This view essentially sees narrower spreads on Nasdaq as having produced an underfunding of securities research (at least in terms of what level of research would be socially optimal). I do not disagree, but doubt that Congress will seek to address this.

[11] Particularly important was Rule 904 on "Display of Customer Limit Orders." See 17 C.F.R. § 242.904.

[12] See 17 C.F.R. § 242.300 et seq.

[13] See the IPO Task Force, "Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth" (October 20, 2011).

[14] See Craig Lewis, "Unregistered Offerings and the Regulation D Exemption" (2011).

[15] See Rule 502(c), 17 C.F.R. § 230.502(c) (barring general solicitation or advertisements in a Rule 506 or 505 offering).

[16] See Rule 504(b)(1), 17 C.F.R. § 230.504(b)(1).

[17] See Gustafson v. Alloyd Company Inc., 513 U.S. 561 (1995).

[18] For a defense of this proposed exemption as a way to employ social media to sell securities, see John Berlau, "Making It Legal to Tweet for Investors," The Wall Street Journal, November 4, 2011 at A-19.

[19] See Rule 701, 17 C.F.R. § 230. 701.

[20] See Form S-3, General Instruction I ("Eligibility Requirements for Use of Form S-3), B. ("Transaction Requirements"), 1. Primary Offerings by Certain Registrants (aggregate market value of common equity held by non-affiliates must be $75 million or more).