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at

Hearings Before the Subcommittee on Capital Markets,
Securities, and Investment

of the

Committee on Financial Services

of the

United States House of Representatives

"Legislative Proposals to Help Fuel Capital and Growth On Main Street"

or

"The Irrepressible Myth That SEC Overregulation Has Chilled IPOs"

May 23, 2018
Room 2128 of the Rayburn House Office Building
Washington, D.C.

Chairman Huizenga, Ranking Member Maloney, and Fellow Members of the Committee:

I. Introduction

I thank you for inviting me. I have been asked to comment on eleven proposed bills, all of which seem to have a common source: a 2018 Report, entitled "Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public," prepared by Sifma and several other industry organizations.[1] The common premise of these bills and the "Expanding the On-Ramp" report is that high regulatory costs and burdensome SEC rules discourage many private companies that would otherwise go public from doing so. That was also the premise of the JOBs Act, enacted in 2012. This premise is a myth, but it is persistently asserted by industry groups seeking to enact a "wish list" of deregulatory reforms.

In that light, and because time is limited, let me make some very basic points:

1. IPO volume crashed in 2001 and has never returned to pre-2000 level.
2. The JOBs Act did nothing to turn this problem around, and indeed IPO volume in 2015 and 2016 was lower than in many years before the JOBs Act.
3. If high regulatory costs and SEC overregulation were a cause of low and decreasing IPO volume, this would be a uniquely American problem. But it is not. IPO volume has declined even more dramatically in Canada and has declined on a level comparable to the U.S. in Europe and Japan.

[1] The other organizations include: (1) The Center for Capital Markets Competitiveness, (2) The American Securities Association, (3) The Biotechnology Innovation Organization, (4) The Equity Dealers of America, (5) Technet; (6) Nasdaq and (7) The National Venture Capital Association.

Because Canada has no national securities regulator, the decline of IPOs in Canada cannot be blamed on an over-regulating national regulator.

4. What then does explain the decline in IPOs? Although there were scandals in 2001 when the "Hot Issue" IPO bubble collapsed (which suggests that under-regulation may be a partial cause), two basic causes of declining IPO volume stand out:

   A. Private companies find it easier, quicker, and cheaper to raise capital in robust private equity markets (where litigation risk is also much lower); and

   B. IPOs for smaller firms have been consistently unsuccessful for a sustained period, losing money for all concerned (both investors and underwriters). Thus, analysts and underwriters tend to shun such offerings. Academic research suggests that the relative disappearance and inprofitability of smaller firm IPOs is because such firms cannot gain the economies of scale and scope than are increasingly necessary to compete in a globalizing marketplace.[2]

5. Is there a crisis? NO! Private companies are tapping ready sources of capital in venture capital and private equity markets. High tech firms (such as Dropbox this year) are doing successful IPOs (but they appear to be mainly motivated more by a desire to provide liquidity to their employees and other holders of their stock options). Other firms (such as Spotify) have pursued "direct listings" (probably again to obtain liquidity for

[2] See Jay R. Ritter, Xiaochui Gao Bakshi, and Zhgongyan Zhu, "Where Have All the IPOs Gone?, " (available on SSRN at https://ssrn.com/abstract=1954788).

employees and stock option holders) and have spurned the format of the classic IPO.

6. What will happen to the smaller firm that cannot access the IPO market? Venture capital firms have long known that prices and premiums are higher in the "M&A" market than in the IPO market. Simply put, the smaller firm can be sold at a higher price/earnings multiple in the M&A market (where the buyer is acquiring control and will therefore pay a control premium). Such a buyer can transform the acquired business and move it to a global scale.

7. In this light, relaxing disclosure and transparency rules and downsizing important corporate governance protections (such as "say on pay" or the Rule 14a-8 shareholder proposal rule) represent a dubious policy for Congress to follow. That is, it is no favor to the retail investor to allow smaller companies to escape full disclosure or to avoid corporate governance norms, when these are precisely the offerings most likely to fail.

8. One last general point: A number of these bills amend or modify specific, existing SEC rules (such as Rules 139, 163 or the rules under the Investment Adviser Act). This amounts to micro-managing the SEC. That might be justified if one does not trust the SEC or considers it hopelessly committed to over-regulation. But this is a Republican SEC and I have not heard anyone describe Chairman Clayton as opposed to de-regulation. In that light, it would make far more sense for Congress to ask the SEC to

study a proposed rule change and report back within a defined period. After all, the SEC can respond in a more nuanced way and has greater expertise and experience. The SEC can also adjust its rules in a more flexible fashion, while Congress adopts permanent rules, carved in stone.

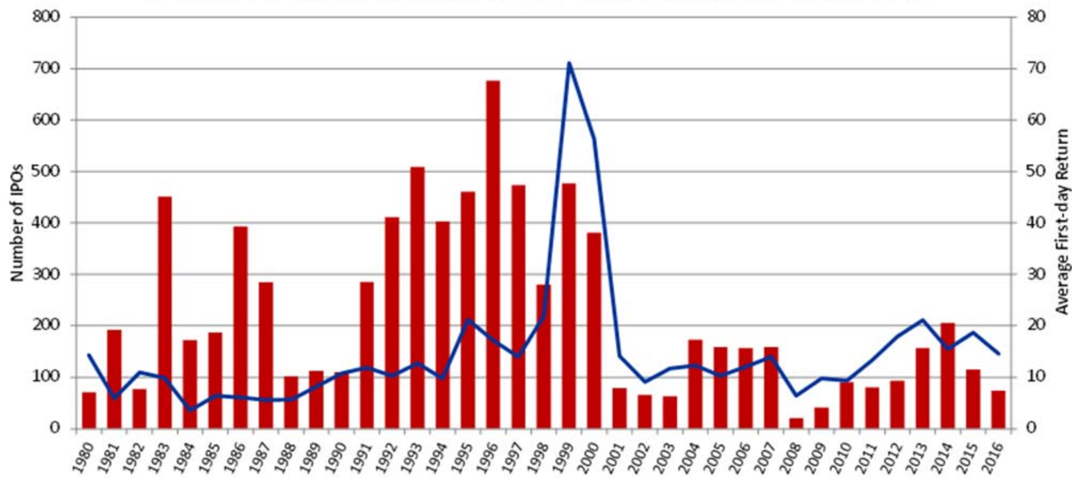
II. The Empirical Evidence on IPO: Volume and Returns

The basic pattern is shown by Exhibit One, which shows that not only have the average number of IPOs declined (from 310 a year in 1980-2000 to 108 from 2001-2016), but the first day returns (and thus the returns that attract investors and underwriters) have declined dramatically:

Exhibit One

IPO volume has been very low in the U.S. since 2000

In 1980-2000, an average of 310 firms went public every year
In 2001-2016, an average of 108 firms went public every year



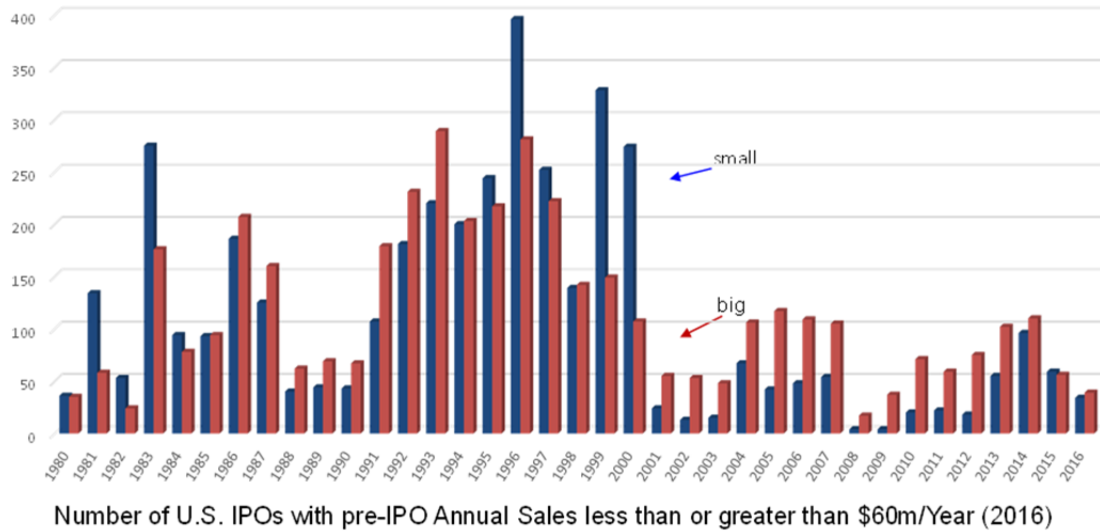
Number of Offerings (bars) and Average First-day Returns (line) on US IPOs, 1980-2016

This pattern has been even more pronounced for smaller firms (defined as firms with annual sales below $60 million):

Exhibit Two

U.S. IPO Volume has been particularly low for small firms

Small firm IPOs are defined as IPOs with less than $60 million in LTM sales ($2016)

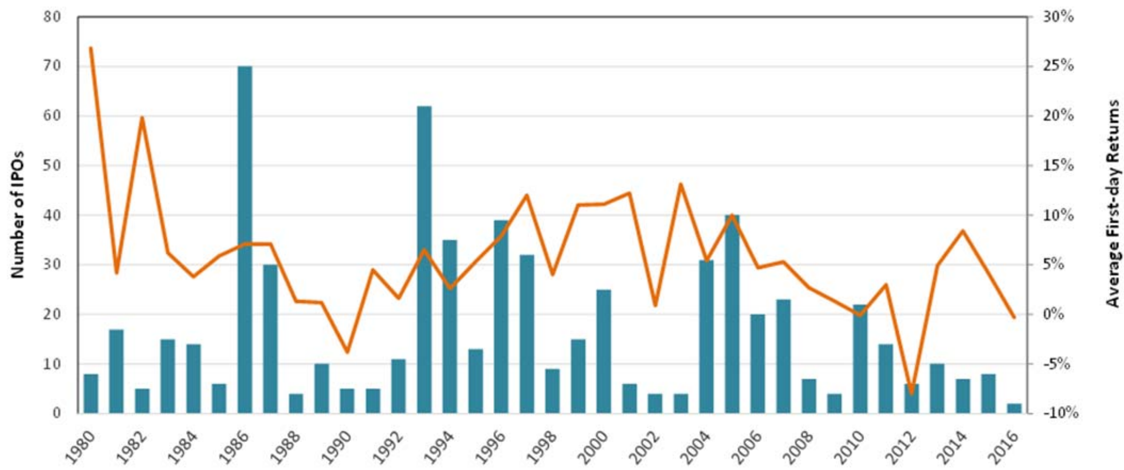


Although "small" IPOs generally outnumbered "larger" IPOs from 1995 to 2000, they have been outnumbered by "larger" IPOs for every year thereafter (with one exception in 2015).

This decline in IPO volume is not unique to the United States. The decline in Canada has been even more extreme (where the absence of a national securities regulator undercuts the argument that overregulation is the cause):

Exhibit Three

Number of Offerings (bars) and Average First-day Returns on Toronto Stock Exchange IPOs, 1980 - 2016



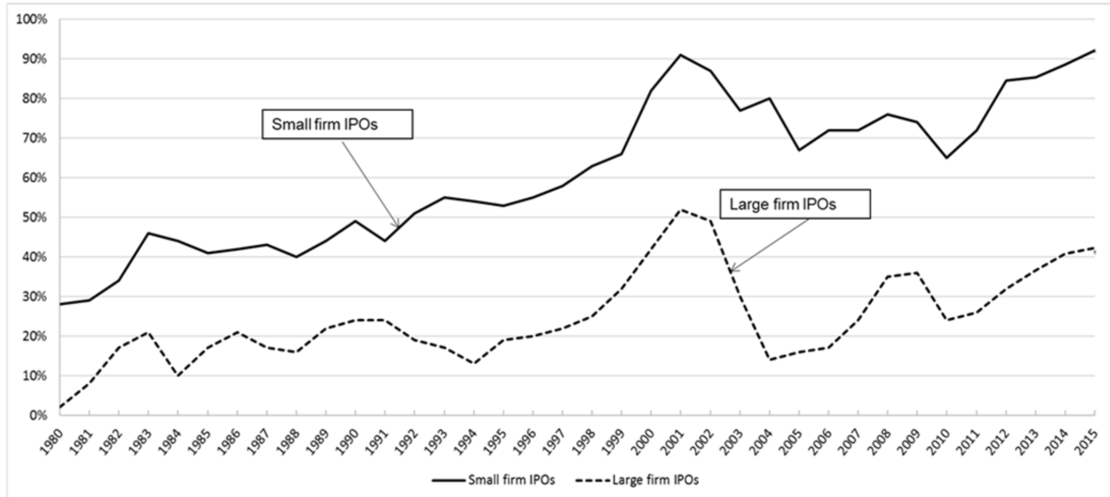
TSX Venture Exchange (and its predecessor, the Vancouver Stock Exchange) IPOs are not included.
Fund and unit offers are not included (only operating companies are counted).

The Canadian experience is particularly instructive because the first day average returns on IPOs have been negative since 2008 (with the lone exception of 2010). This same decline in IPO volume and returns has also characterized Europe and Japan. Across all the developed securities markets, only China has recently experienced an exuberant and growing IPO market.

Small firm IPOs fare especially poorly in terms of earnings per share ("EPS") following their IPO. Ritter, Gao, and Zhu measure the percentage of both "large" and "small" IPOs that experience negative EPS in any fiscal year. They find that the percentage of "small" IPOs (from the prior three years) with negative EPS in any given year has ranged between 65% and 90% since 1999. In contrast, "large" IPOs (from the same prior three years) have generally had positive EPS over the fiscal years since 2002:

Exhibit Four

Small firm IPOs have become less profitable



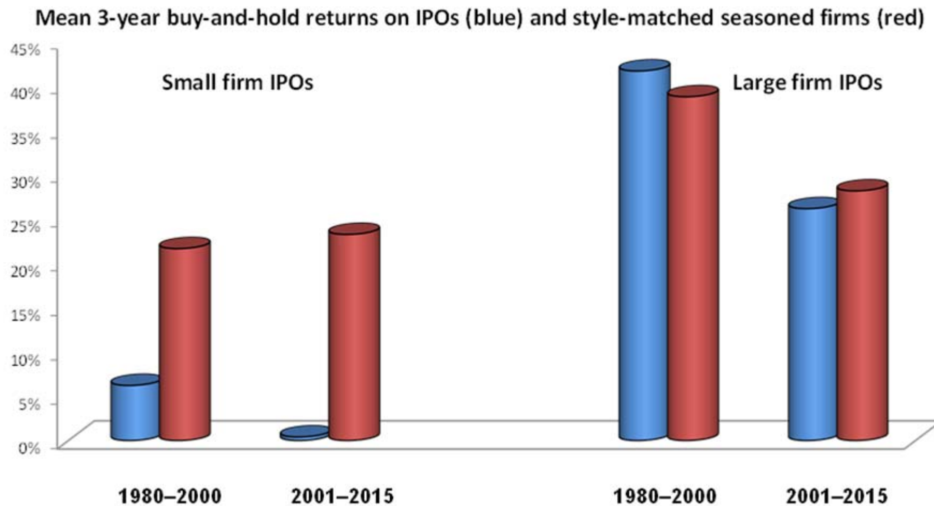
Percentage of U.S. IPOs from the prior 3 years with negative EPS in fiscal year t

Source: Table 2, columns 2 and 4 of Gao, Ritter, and Zhu "Where Have All the IPOs Gone?" December 2013 *Journal of Financial and Quantitative Analysis*, updated

In short, large IPOs make money, while small IPOs lose money in subsequent years. The buy-and-hold returns on small IPOs reflect this reality:

Exhibit Five

U.S. small firm IPO returns have been disappointing



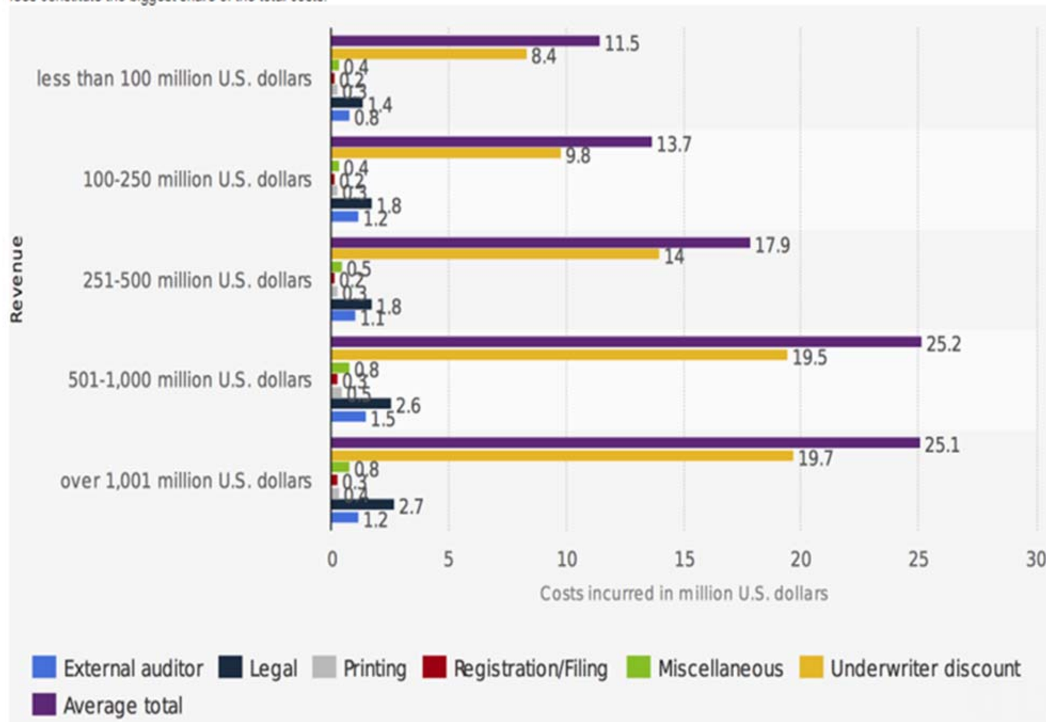
$60 million in inflation–adjusted pre-IPO annual sales cutoff,
returns not including first-day return and ending in Dec. 2016

III. The Cost on an IPO: Direct and Indirect

A key assumption to both the JOBs Act and the proposed legislation before this Subcommittee is that deregulation can significantly (or even moderately) reduce the costs of an IPO. But this is highly doubtful. The following chart, taken from a PriceWaterhouse Coopers study, shows that across all sizes of IPOs (small to large), the underwriting discount accounts for between 71% and 79% of the total average costs:

Exhibit Six

<u>The Costs of Going Public</u>



<u>Bottom Line</u>: The underwriters discount dominates, with legal fees and public auditing costs ranking second and third. Costs directly attributable to the SEC and other regulators are relatively modest. For the $500 million and larger IPO, the underwriters' discount amounts to nearly 80% of all costs.

Nothing else comes close to the underwriters' discount, with legal and audit costs coming second and third. Legal fees range between 10% to 13% of the total costs. The actual SEC registration and filing costs are trivial and in the 1 to 2% range). Although these proposals might reduce legal and auditing costs somewhat, the reduction would be modest to an already minor cost.

In reality, the "real" costs of an IPO are hidden, and include the costs of diverted executive time, the costs of a now multinational "roadshow," and the potential litigation costs. Some privately-held companies simply do not believe that they can spare time for an IPO when they are locked in intense competition with often larger rivals. Others fear a stock price drop might spur litigation. Still, others doubt that their IPO price

would be as high as their valuation in their last round of private financing (and some recent IPOs have fallen below that level). But these reasons have little to do with the direct financial costs of an IPO.

This is not to say that many private companies would not like to avoid some of the burdens that these bills would spare them from (if they were to go public). Yes, they would like to avoid "say on pay" votes and shareholder proposals by activists (which are made under SEC Rule 14a-8). Similarly, they might prefer a world in which proxy advisors (such as I.S.S. and Glass-Lewis) were closely regulated into relative silence (as is also proposed in "Expanding the On-Ramp"). But such proposals all reduce shareholder rights and involve very problematic trade-offs. Nor will all "emerging growth companies" necessarily be attracted by such deregulation. Suppose, for example, that three new IPOs are caused by eliminating "say on pay" votes for EGCs, but 100 EGCs are thereby deregulated. The costs and benefits of such a move seem open to serious debate. In the next section, some of the specific trade-offs are examined.

IV. Proposed Legislation

These bills have very different impacts, costs, and benefits. Thus, each needs to be considered separately:

1. H.R. 5054 (the "Small Company Disclosure Simplification Act of 2018").

This is "Improvement Nine" in the "Expanding the On-Ramp" platform and it would exempt covered issuers from XBRL (an interactive data format that allows analysts to compare data across companies through a standardized layout). This proposal seems overboard because it would exempt not only EGCs, but also more mature "non-

accelerated filers" that may have been "reporting companies" for many years. Also, there is some inconsistency here between the recurring complaint in "Expanding the On-Ramp" that analysts do not conduct sufficient research on smaller firms and this proposal that makes such research harder (and more costly) to conduct.

Personally, I cannot advise this Subcommittee whether the XBRL format is important in this context, but that is precisely the question that should be asked of both the SEC and institutional investors. As with many other proposals in this package, this proposal seeks to micro-manage the SEC without first inquiring what the SEC's views are.

Overall, this is not among the more important proposals in this package, but some inquiry should be made of securities analysts and bodies such as the Council of Institutional Investors ("CII").

2. H.R. 5756 (Resubmission of Shareholder Proposals Under Rule 14a-8)

This is "Improvement Two" in "Expanding the On-Ramp," and it will be highly controversial. Essentially, it would move the "resubmission" standards up from 3%, 6%, and 10% to 6%, 15%, and 30%, respectively -- in effect, more than doubling them. Essentially, this resurrects a proposal made in 1997, which the SEC dropped as a hot potato. It will be no less controversial today.

Initially, it should be noted that this proposal has relatively little to do with EGCs or IPOs, and would apply as well to IBM, Citicorp, or Apple. Although it would apply to all issuers, it has been endorsed only by representatives of venture capital and other small issuers. Because it very much implicates the interests of "socially

responsible" and "sustainable growth" investors (many of whom are institutional investors and mutual funds), I would urge this Subcommittee to elicit their views on an issue that is important (and even critical) to many of them. In addition, the views of the principal proxy advisory firms (I.S.S. and Glass-Lewis), the C.I.I. and bodies such as the Investor Responsibility Research Center (I.R.R.C.) should be solicited, as their interests are significantly affected and they have closer contact and expertise with respect to the shareholder proposal process than do the proponents of this measure).

In recent years, investors have shown increasingly interest in "Environmental, Social and Governance" proposals (usually dubbed "ESG" proposals and have voted for them in increasing percentages. Such proposals now sometimes win. But typically, they may start with an initially low level of support (potentially, below 6%). Thus, they would be denied resubmission under this proposed standard. Shareholder proposals may receive an initial low level of support because a process of investor education is necessary.

Some institutional investors (most notably, BlackRock) have announced this year that they intend to invest greater resources and personnel in monitoring ESG proposals, and this proposal flies in the face of that enhanced investor interest. Moreover, "Expanding the On-Ramp" cites no data or empirical evidence for its position, but just makes a blanket judgment that shareholder proposals should be cut back. That is too glib.

Shareholder proposals can play a "safety valve" function in corporate governance, allowing issues to be presented that need attention: for example, gender diversity on boards, climate change, executive compensation, etc. This attempt to silence these proposals will do little to encourage more IPOs, but will suppress needed debate.

3. H.R. ___ ("Main Street Growth Act," providing for the Registration of Venture Exchanges)

The idea of a "venture exchange' is promising and has had some success in the U.K., and Canada but the statutory language proposing this concept unduly restrains the SEC. Under this language, venture exchanges are to be recognized and deemed registered unless the Commission denies the application within six months. Such an exchange may trade securities of any EGC, but other provisions in this package of bills expand the definition of EGC by (i) stripping away the limitation on large accelerated filers, and (ii) allowing firms to continue as EGC for ten years. Further, issuers, trading in this market should be required to make much continuing disclosures as public "reporting" companies, scaled down somewhat to reflect their lesser size. A compromise here needs to be worked out before this idea is truly ready for adoption. These inconsistencies need to be worked out, and it would be preferable if the Commission came forward with its own more nuanced and better researched proposal. Congress should instead encourage the Commission to make such a proposal. Possibly, such a proposal might encourage some "unicorns" to take a half step toward becoming public companies.

Nonetheless, one provision in this bill is especially problematic. Securities traded on "venture exchanges" would be exempted from states' "blue sky" laws (while securities traded "over the market" on ATS systems are not exempted). This is an unjustified disparity, in part because this is the area of small company trading where the state regulators have been most effective.

4. H.R._____ (Rule 163)

This bill proposes that Congress rewrite a specific SEC rule (Rule 163), and thus it again seems to be micro-managing the SEC. Beyond that, it also misunderstands the goal of Rule 163. Rule 163 exempts certain very large corporations (known as "Well-Known, Seasoned Issuers" or "WKSIs") from the gun-jumping rules of Section 5(c) of the Securities Act. This exemption reflects the fact that these large issuers also have the obligation to provide timely information to their shareholders (and hence cannot remain silent as a smaller IPO firm generally can in the "quiet" period). Indeed, its number of shareholders may greatly exceed the number of prospective offerees in an approaching equity offering. But this proposal gives beyond permitting the issuer to communicate timely information to its shareholders and would permit underwriters actually to sell the securities to them -- before a registration statement had been filed. This would overturn a key premise of the Securities Act: that actual selling not occur until the issuer had prepared and filed a registration statement with the SEC that contains all material information about the offering. That would tend to make the registration statement irrelevant or only a souvenir of the transaction. That is, the deal could be entirely sold before anything is filed with the SEC.

Finally, I must observe that this is a proposal relating not to IPOs or smaller firms; but to giant corporations conducting large offerings. It is thus totally unrelated to encouraging IPOs in any meaningful way. Thus, it reveals that the relatively unrelated proposals in this "Expanding the On-Ramp" are simply the "wish list" of a variety of industry groups -- without any close connection or logic. This idea has also been floated in the past and abandoned by the SEC -- for good reason!

5. H.R.____ (Directing the SEC to increase and align the smaller reporting company definition and non-accelerated filer thresholds).

This is Recommendation One (at p.27) of "Expanding the On-Ramp's" "Recommendation Related to Financial Reporting." As proposed in that document, the SEC should conduct an elaborate rulemaking "study of the costs and benefits of such an approach." However, the proposed legislation simply directs the SEC to take very specific action with very specific thresholds and thus abandons the idea of a rulemaking study. That is unwise. Administrative agencies have greater experience and expertise than Congress and are better positioned to draft bright-line standards.

Again, this bill reflects a certain distrust of the SEC, which seems peculiarly inappropriate when the SEC has a cautious, careful Chairman that no one has accused of a bias towards over-regulation.

I take no position of exactly where the thresholds should be but only suggest that this question needs objective study.

6. H.R.____ (mandating SEC study of research coverage of small, pre-IPO issuers)

I have no objection to such a study (and would encourage it), but I do anticipate some of the likely findings. Because smaller IPO offerings have been consistently unsuccessful and unprofitable (both in issuer earnings and first day returns), underwriters and, in particular, analysts associated with unaffiliated broker-dealers do not want to waste resources or become involved with unpromising transactions.

Congress should also be mindful of some limits on its power. There could even be a First Amendment limitation on any attempt by Congress to mandate that

underwrites (or particularly unaffiliated brokers and analysts) publish research studies on impending IPOs.

To be sure, there are ways that Congress could seek to subsidize such research (possibly by asking exchanges, as other nations do, to bear some of the costs of such research and pass the cost onto all brokers and dealers on that exchange). But such a proposal (which has been adopted in other countries) is too complicated to discuss in this testimony.

7. H.R.____ (removing the prohibition on large accelerated filers qualifying as EGCs).

This is essentially "Enhancement Four" in "Expanding the On-Ramp's" proposed "Enhancements to the JOBs Act" (see p. 12). From my humble perspective, there is a basic contradiction here: you are hardly an "Emerging Growth Company" if you are also a "Large Accelerated Filer." Conceptually, it is hard to be both small and large at the same time.

More importantly, this proposal exempts large companies (namely, large accelerated filers) from the disclosure requirements applicable to most issuers. This is a far cry from a temporary bridge for EGCs, but rather concludes that, to induce IPOs, Congress should let the big issuer remain exempt. It is highly unlikely that this strategy will work, because this incentive has not induced many IPOs in the years since 2012. But even if it did work (to some degree), it institutionalizes a two-tier disclosure system, based not on size, or public float of the issuer, but on when the issuer went public.

Ultimately, eliminating the "phase out" rules (such as the "large accelerated filer" condition) does not encourage new IPOs (because the recipients of this

exemption have already "gone public" years ago). No doubt, some public companies would like to remain EGCs, but that creates a permanent two-tier market, not a transitional brdge.

8. H.R. ____ (to provide a five year extension for EGCs)

This is "Enhancement One" to the "Expanding the On-Ramp's" "Enhancements to the JOBs Act" (at p.10). The core idea to the JOBs Act was to create a five-year bridge for EGCs to transition to full "reporting company" status. EGCs are now lobbying to make this bridge permanent. If they get their additional five year extension, there can be little doubt that these same EGCs will seek another exemption in five more years (and may succeed in recreating a permanent exemption, regardless of their size, earnings, or public float).

The result is likely to be a permanent two-tier disclosure system in which EGCs never are required to make the same disclosures as those companies that went public before 2012 (the date of the JOBs Act). The only rationale for such a bizarre system is that it might conceivably cause firms to "go public" that otherwise would not. But the evidence to date does not suggest that JOBs Act has provided any strong incentive. To be sure, high-tech "unicorns" do go public (as Dropbox exemplified this year), but they want until it is possible to obtain an IPO valuation well in excess of their prior valuation in this private equity market (and many "unicorns" cannot obtain such a valuation and so remain on the sidelines). Other private companies may follow Spotify and do a "direct listing". But smaller companies will not have this opportunity and will turn instead to the M&A market where they receive much higher valuations. Unfortunately, the JOBs Act's cost-saving subsidy thus goes to high-tech offerings

(which need no such subsidy) and does not motivate smaller companies (because such offerings are unprofitable).

9. H.R. ___ (replacing Form 10-Q with a press release)

This is "Improvement Three" in the "Expanding the On-Ramp" proposals. It would grant EGCs the option of replacing Form 10-Q with a press release. This is one of the worst ideas in this package, because over time it would undercut our quarterly reporting system. If EGCs receive a ten year exemption from most quarterly disclosures, this will create predictable political pressure for further time extensions and eventually a permanent exemption. Eventually, those older companies still subject to quarterly disclosure will lobby for corresponding exemptions.

Substituting a press release for a Form 10-Q is not a small change. A press release need only disclose revenues and earnings (if that), and need not provide full financial statements. Today, the Form 10-Q contains important forward-looking information in its "MD&A" section, and this information will likely no longer reach investors in the exempted companies. This retreat from full disclosure and transparency is substantial (even if it is here masked as a minor change).

Although investors would thus lose much transparency, there is no real evidence that this incentive will produce any significant increase in IPOs (and little evidence suggests that this has happened since 2012). Nor is there evidence that inducing successful companies in the private markets to list in the public markets produces significant gains for the economy. Further, the many "unicorns" now waiting on the sidelines in the private markets are not waiting to realize minor cost savings in going

public. Rather, they are largely waiting for the optimal moment when they can obtain a valuation well in excess of the already high valuation they enjoy in the private market.

10. H.R. (to allow purchases of EGC shares to be qualifying investments for purposes of the Registered Investment Advisor exemption)

This is "Improvement Five" to the "Expanding the On-Ramp" proposals (see p.21) Once again, this is a legislative edict that would amend SEC rules (here Rule 203(1)-I under the Investment Advisors Act), and the views of the SEC have not yet been requested (or at least made public).

The impact of this proposal would likely be modest (and I do not suggest that it is necessarily undesirable), but it would be preferable to place the horse before the cart and ask the SEC if it is willing to amend its rules (or explain why not) before repealing these rules.

11. H.R. ___ (to increase mutual fund diversified limits from ten percent to fifteen percent)

This is "Improvement Ten" to the "Expanding the On-Ramp Proposals" (See p.24). It may well be a sensible proposal, but the SEC's views on it have not been made public. I tend to doubt that many mutual funds will be willing to hold 15% stakes (as opposed to 10% stakes) in a portfolio company, because, once over 10%, they are generally subject to Section 16(b)'s "short-swing" profit recapture provisions (and they also are likely to encounter greater liquidity problems in selling such a large state). But the idea is plausible.

Conclusion

This package of bills proposes major retreats in disclosure and corporate governance in order to encourage some additional IPOs. The evidence to date does not show any significant response to the larger concessions made in the JOBs Act in 2012. Moreover, these proposals may turn a transitional bridge into a permanently two-tier disclosure system.

Not all these proposals are necessarily wrong-headed, but they have not been vetted adequately by the SEC or other concerned constituencies. Some -- most notably, the modifications to the shareholder proposal rule (Rule 14a-8), the say-on-pay rules, and the generally hostile attitude toward proxy advisory firms -- represent major retreats in corporate governance. Other proposals -- most notably, the substitution of a press release for a Form 10-Q -- significantly reduce transparency and would predictably encourage other issuers to demand parallel exemptions.

The costs seem real, while the benefits may be illusory. There is no crisis demanding major deregulation. Although smaller IPOs will continue to decline, the much larger "unicorns" are simply biding their time. Eventually, they will go public, but small cost incentives will not motivate them.

If these bills pass, one prediction is safe: in five more years, we will see JOBs Act III, based on the same dubious assumptions.