Testimony Pertaining to the Hearing:
"Examining the IPO Process: Is it Working for Ordinary Investors?"

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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 publically 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 pre-screened 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.)

<u>Institutional Investors:</u> 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% 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.

<u>Retail Investors:</u> 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 non-public 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 sub-prime 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 mis-step 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.