

Highlights from the SEC-NYU Dialogue on Reviving the U.S IPO Market¹

The second SEC-NYU Dialogue on the state of the U.S. IPO market was held on May 10, 2017 at New York University's Salomon Center for the Study of Financial Institutions. The dialogue brought together practitioners, regulators, and academics to learn, engage, and discuss the current state of the U.S. IPO market and what can be done to revive IPOs in the U.S.

Highlights from Panel 1: Review of the IPO Market

Panel 1 presented a review of the current state of the U.S. IPO market from an academic perspective, including a discussion of the economic causes and consequences of the continued weak IPO market.

Prof. Rene Stulz from Ohio State University presented and discussed several empirical findings that may be related to recent trends in the U.S. IPO market.

- Prof. Stulz showed that listings in the US have declined, while listings in other countries have increased. He noted that the decline in the U.S. markets is due to low levels of new listings and high numbers of delistings, much of which have been driven by M&A activity.
- Prof. Stulz further stated that the fraction of small cap firms declined over time as well, noting that, in the 1990s, 65% of companies were "small cap," while in 2016, only 22% of U.S. companies were small cap.² According to Prof. Stulz, the importance of institutional investors has grown over time and has tilted the composition of U.S. securities toward larger public firms. Small firms will continue to struggle to exploit economies of scope as well as gain momentum in innovation in global markets.
- Prof. Stulz also documented that the number of listed firms with losses has increased over time and that there has been a shift to greater R&D investment relative to capital expenditures. As stated by Prof. Stulz, the growing importance of R&D means that it is more difficult to finance firms via public offerings. Firms have also turned to increased use of outsourcing, noted Prof. Stulz, which leads to lower capital requirements for these firms. As a result, many firms have been availed a capital surplus, where cash flows exceed new investments by firms. Further, he noted that repurchases are overtaking new securities issuance for most companies.
- Prof. Stulz also discussed that the benefits of going public have declined, while costs of IPO have actually declined. Further, changes in intermediation have both decreased the search costs and increased the ease of private financing.

¹ These Research Notes were prepared by Vladimir Ivanov and Jennifer Juergens, in the SEC's Division of Economic and Risk Analysis. The Research Notes are based on staff observations during the conference and are not a transcript of the event. As such, the Research Notes do not necessarily include the entirety of the panel discussions or the complete views of the panelists. Further, the views expressed by the panelists, and summarized herein, are the panelists' own, and do not necessarily reflect the views of the Commission or Commission staff. To view the webcast of the panel discussions, please visit the website here.

² See Doidge, Craig, Andrew Karolyi, and Rene Stulz, 2017, The U.S. Listing Gap, Journal of Financial Economics 123, 464-487.

- Regulation should try to tilt the playing field back towards public firms, according to Prof. Stulz. For example, he suggested that corporate taxation of dividends could be repealed for public firms.

Prof. Roni Michaely from Cornell University summarized recent findings of the empirical IPO literature, particularly focusing on recent working papers presented at an NYU's conference on May 9, 2017, "The Changing Role of Stock Markets in Capital Formation."

- As documented in Prof. Michaely's research, US industries are becoming more concentrated – the majority of US industries have lost about 50% of their public firms, and the remaining public firms have grown in size. The share of the largest four firms in any industry has increased from 1997 to 2014.³ This increased concentration is prevalent in both public and private firms. For publicly-traded firms, profitability of firms in industries with declining competition is increasing, as are returns to shareholders of those firms, according to Prof. Michaely.
- As Prof. Michaely explained, technology, innovation, and regulatory changes (particularly those related to enforcement policies of antitrust laws) have contributed to increasing concentration.
- Empirical evidence presented by Prof. Michaely suggests that raising capital is not a primary reason for going public. According to empirical studies, firms retain most of the capital raised in an IPO and use only about 30% of proceeds to increase investment, and when firms do an IPO, the firms tend to be overvalued.⁴ Further, the increased participation of mutual funds in pre-IPO firms indicates that a new source of capital is increasingly available to private firms.⁵
- Prof. Michaely cited other reasons that firms go public, including an exit venue for pre-IPO investors (e.g., venture capitalists), shareholder diversification, and certification of the firm's value. Going public, according to Prof. Michaely, could be considered a public good because it may provide lower cost of capital, better capital allocation, higher economic growth, better monitoring of firms, and increased diversification opportunities for investors.
- Prof. Michaely suggested changes in laws and regulations could alter the current downward trend in U.S. IPOs by making private firms look more like public firms. He proposed that private firms could be subject to the same accounting standards as public firms, and he believes that the SEC should encourage mutual funds directly (or indirectly) take ownership in private firms.

Prof Alexander Ljungqvist from New York University focused his discussion on the economic consequences of the IPO decision by firms.

- According to Prof. Ljungqvist, both investors and companies make privately optimal decisions. Investors may make the privately optimal decision to invest in larger firms, while companies may make the privately optimal decision to stay private or delist. Such decisions, however, may

³ See Grullon, Gustavo, Yelena Larkin, and Roni Michaely, 2017, Are U.S. Industries Becoming More Concentrated?, Working paper, Cornell University.

⁴ See Kim, Woojin, and Michael Weisbach, 2008, Motivations for Public Equity Offerings: An International Perspective, *Journal of Financial Economics* 87, 281-307.

⁵ See Kwon, Sungjoug, Michelle Lowry, and Yiming Qian, 2017, Mutual Fund Investments in Private Firms, Working paper, Drexel University.

not be socially optimal. There potentially exists both negative and positive externalities from such privately optimal decisions, noted Prof. Ljungqvist.

- Prof. Ljungqvist identified five potentially negative externalities associated with choosing to stay or go private:
 - o Cost of capital may increase for all firms, which leads to less investment, innovation, and job creation, all else equal;
 - o Capital misallocation and distortions can arise in product markets because of lack of investor scrutiny and proper price discovery;
 - o Firms that agree to sell themselves to another firm have the potential to harm consumers through reduced competition;
 - o Reduced political support for shareholder capitalism can occur; and
 - o Wealth inequality may arise as access by retail investors to the wealth generated by newly public firms may be limited.
- However, Prof. Ljungqvist noted that a positive externality from choosing to stay or go private is a potential long-term investment focus, which could result in more innovation, job creation, and investment.

Highlights from Panel 2: Panel on Regulatory and Other Market Influences

Panel 2 generated a discussion of what has led to the current state of the IPO market, including changes in technology and funding sources, the macroeconomic environment, and regulatory and institutional influences, as well as a discussion on the challenges these issues pose for firms seeking to raise capital.

Chris Cooper from Sequoia Capital argued that the following developments have influenced the state of the U.S. IPO market:

- Globalization has played a significant role in the slow-down of IPOs, according to Mr. Cooper, as it has resulted in a large influx of foreign private capital going to hi-tech firms.
- Mr. Cooper stated that firms have accumulated large cash balances, and therefore, do not have much need to raise new capital.
- High premiums, as noted by Mr. Cooper, have been paid to acquire companies, to take companies private, and to reduce the net public float in public markets.
- Mr. Cooper remarked that angel investing, seed investing, and incubation as mechanisms to support of small firms has grown significantly over the last decade.
- Regulation, according to Mr. Cooper, is not the driver of the weak IPO market; instead, it is largely driven by macro factors. Regulation helps firms on the margins, primarily by making it easier and cheaper to go public, and it is likely to make companies more sound.
- Mr. Cooper stated that U.S. IPO markets should try to get an advantage over foreign markets. He noted that higher valuations and dual-class stock are examples of such advantages.

Adam Smith from KKR argued that staying private longer brings important advantages for firms considering going public. It allows firms to become larger and have better earnings, thereby permitting

these firms to be “healthier” when entering the IPO process. He outlined the following reasons for the decline in the number of IPOs:

- According to Mr. Smith, the main driver of the choice of exit venue is valuations. Companies are going to list where the valuations are the highest. Currently, as noted by Mr. Smith, valuations are higher in China and Hong Kong, as evidenced by the number of first quarter 2017 IPOs (140) relative to the U.S. markets (50).
- In today’s environment, if a company wants to grow, Mr. Smith stated that it generally will utilize private markets. If its investors are thinking about an exit, then the IPO market comes into play, although, according to Mr. Smith, the best way to grow in recent years is through M&A.
- Mr. Smith suggested that increasing sophistication of sovereign funds, an influx of large family offices, and lower returns from traditional investments have also led to more investments in private firms.
- The JOBS Act made it easy and cheaper to go public, according to Mr. Smith, and confidential filings are especially valued by private firms that are about to go public.

Steven Bochner from Wilson Sonsini noted that staying private longer does not mean that firms will stay private forever, as investors in private firms need to exit at some point in time, and liquidity in shares can be obtained from either IPOs or M&A. Mr. Bochner also argued that encouraging firms to go public earlier may not be optimal. Further, accredited investors should be excluded from the 12g count according to Mr. Bochner. He provided the following insights for the weaker IPO market:

- The JOBS Act, according to Mr. Bochner, is a good tool for firms to explore the public markets but provides only incremental benefits to firms going public. He posited that the main benefits attributable to the JOBS Act are confidential submission, the opportunity to test-the-waters, and further accommodations and scaled disclosure should be considered.
- Mr. Bochner predicted there will be more companies going public in the near future because venture capitalists need to exit and employees need liquidity.

Frank Hatheway of NASDAQ believed that the current market structure is favorable for large companies but puts small public firms at a disadvantage. The market has an appetite for large firms, according to him.

- Dr. Hatheway stated that it is possible that a revision to the “one size fits all” model of markets needs to occur.
- Although there are private market liquidity providers, such as NASDAQ Private Market, that provide liquidity for employers/employees, these liquidity providers are only a partial solution to the liquidity problem, according to Dr. Hatheway. Only exit through an IPO can fully solve the liquidity problem of private companies.
- Dr. Hatheway observed that dual class shares should be used to protect the founders and to encourage long-term decision making.

Highlights from Panel 3: How to Revive the IPO Market

Participants in Panel 3 discussed the declining IPO market and what can be done to revive it, focusing on possible solutions driven by the needs of IPO market participants as well as potential regulatory responses.

Thomas Farley, of the New York Stock Exchange, offered the following reasons for why IPOs, especially the small ones, have decreased in numbers:

- Regulation, including Sarbanes-Oxley, Dodd-Frank, and JOBS Act, has had an impact on the IPO market, according to Mr. Farley. He argued that many of these regulations have done a lot of good, “but not all.”
- Mr. Farley noted that companies are afraid of the short-term pressure of the public market and activist investors.
- Mr. Farley further observed that the ecosystem for trading small IPO stocks does not exist and that a concentration of liquidity, namely reducing the number of possible trading venues, for small securities may be an alternative to consider.
- Mr. Farley also remarked that the litigious environment of the IPO market “scares off” private firms from becoming public.
- There is important social good in broad investor inclusion, and in particular retail investors, in the capital markets, according to Mr. Farley. Generally retail investors cannot access private equity, and so they miss out on these opportunities.

Robin Graham from Oppenheimer & Co. noted that previously firms used the public capital markets to raise capital, whereas now they mainly seek liquidity in those markets, thus shifting the mix of firms that go public to more mature and predictable businesses.

- Regulatory cost is too small to explain the drop in IPOs, according to Mr. Graham. He stated that ability to engage in confidential filing and to test-the-waters (as part of the JOBS Act) have been beneficial to firms.
- Mr. Graham noted that the time allocated by management to address filings and reporting documents for a public company is significant. One possible solution proposed by Mr. Graham is to reduce corporate reporting to twice a year.
- Further, private capital comes with active investors that could help small firms in many ways, Mr. Graham argued.
- Mr. Graham also pointed out that there has been an increase in the number of crossover investors – i.e. m=, investors that invest in public and private firms. These investors, according to Mr. Graham, invest in small growth private companies to get exposure to small firms, and thus, may not need small public firms.

Conor Kehoe, from McKinsey & Company, argued that the healthiest companies focus on long-term goals, but public companies tend to be subject to short-term pressure and may underperform relative to their true economic potential. Mr. Kehoe further suggested that there is a need to make the public capital markets more attractive to corporations and that although firms come to the markets for

liquidity, there is also a need for the governance and stewardship that only public markets can provide. He offered the following five suggestions for better governance of public firms:

- Avoid earnings guidance;
- Speak about the long term;
- Avoid quarterly earnings;
- Get non-executive directors involved in the company's business, as uninformed non-executive directors are more susceptible to short-termism;
- Institutional investors should behave in a way that reflects the duration of their investments.

Rick Fleming from the SEC's Office of Investor Advocate, who served as moderator for Panel 3, noted that ownership of equity has switched from individual investors to institutional investors and suggested that this switch may explain the lack of small IPOs. According to Mr. Fleming, it is important to make small firms more attractive to institutional investors.