THE HIGH COST OF IPOs DEPRESSES VENTURE CAPITAL IN THE UNITED STATES

DALE A. OESTERLE*

The fundamental reason for the small numbers of IPOs is the reluctance of public investors to buy IPO stock. The technology bubble burst in 2000 and investors still remember their losses in the IPO industries. But the IPO market would be more active if IPOs were not so expensive. They cost too much to do and, once done, a company has much higher ongoing costs. The higher ongoing costs are a significant bone of contention, particularly with the implementation of Section 404 of the Sarbanes-Oxley Act of 2002.

Lowering the cost of IPOs would not only enable small companies to net more money per offering, it would also enable small companies to float smaller offerings. And lowering the cost of IPOs is something that the Securities and Exchange Commission could do by allowing small companies to make their IPOs over the Internet. The SEC's foot-dragging on the use of the Internet for IPOs is depressing venture capital in the United States. The most active venture capital IPO market for small companies is now the AIM market in London.

This comment briefly describes the current regulation of IPOs, describes an alternative system of public offering that uses the Internet, and concludes with a discussion of whether there are regulatory problems with a system of Internet IPO.

Entrepreneurs in the United States depend on venture capital for funding the formative years of their operations. The willingness of venture capitalists, angels, and venture capital funds to place funds with portfolio

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2 Venture capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant
companies depends on predictions of high rates of return for these high risk investments. The most robust of these predictions depend on the anticipated sale of the company within the next seven to ten years to the public, in an Initial Public Offering ("IPO"). Since the number of IPOs has been down for the past several years, venture capital funding has been correspondingly flat.

The fundamental reason for the small numbers of IPOs is, of course, the reluctance of public investors to buy IPO stock. The technology bubble burst in 2000 and investors still remember their losses in the IPO industries. But the IPO market would be more active if IPOs were not so expensive. They cost too much to do and, once done, a company has much higher ongoing costs. The higher ongoing costs are a significant bone of contention, particularly with the implementation of Section 404 of the Sarbanes-Oxley Act of 2002. This paper, however, will focus on the costs of the IPO itself.

In the United States, a small company has to pay too much in fees and discounts when it sells its stock to the public. A small company selling fifty million dollars of its equity, as measured by the market price at the end of the first day, of an IPO with a market value of over fifty-three and a half economic contributors. Nat’l Venture Capital Ass’n, The Venture Capital Industry: An Overview, http://www.nvca.org/def.html (last visited Aug. 4, 2006).


Professionally managed venture capital firms generally are private partnerships or closely-held corporations funded by private and public pension funds, endowment funds, foundations, corporations, wealthy individuals, foreign investors, and the venture capitalists themselves. Nat’l Venture Capital Ass’n, supra note 2.

GAO Report, supra note 3, at 10 (noting that both venture capital funds and angel investors tend to focus on high-growth, high-return investment opportunities).

Id. A future IPO also provides a valuable exit opportunity for investors to liquidate their investments through sale to the public. See also Douglas J. Cumming & Jeffrey G. MacIntosh, Venture-Capital Exits in Canada and the United States, 53 U. Toronto L. J. 101, 104-05 (2003) (study concluding that IPO exits are central to the venture-capital process, and the most selected form of exit for highly-valued firms).


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millions can net only forty-five million dollars in cash or less, a seventeen percent or more charge. More perversely, those who charge to do the IPOs, underwriters, are uninterested in the smaller offerings; underwriters do not make enough money on the small offerings to justify their expenditure of time on them. A small company that wants to raise twenty-five million dollars cannot find an underwriter; a fifty million dollar IPO is a practical minimum.

Lowering the cost of IPOs would not only enable small companies to net more money per offering, it would also enable small companies to float smaller offerings. And lowering the cost of IPOs is something that the Securities and Exchange Commission (“SEC”) could do by allowing small companies to make their IPOs over the Internet. The SEC’s foot-dragging on the use of the Internet for IPOs is depressing venture capital in the United States. The most active venture capital IPO market for small companies is now the AIM market in London.

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I. THE UNITED STATES IPO

9 Assuming an underpricing of approximately seven percent, see Table 1, infra.
10 $53.5 million (value) - $3.5 million (underpricing, Table 1, infra) - $5 million (estimated fees/expenses).
11 GAO REPORT, supra note 3, at 22 (stating that businesses doing IPOs of less than $50 million have difficulty in attracting larger investment banking firms to underwrite the offerings, due to high fixed costs and economies of scale, and are distributed by lower-tier investment banks that are less attractive to potential investors).
13 See id. at 453 (noting that equity “direct public offerings” have typically been completed by smaller issuers trying to raise a small amount of capital).
14 See id. at 439.
15 See Final Report of the Advisory Committee on Smaller Public Companies (“ACSPC”) to the Securities and Exchange Commission (2006), http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf (last visited Aug. 4, 2006), at 75: [H]owever, the current ban on general solicitation and advertising effectively prohibits issuers from taking advantage of the tremendous efficiencies and reach of the Internet to communicate with potential investors who do not need all the protections of the Securities Act’s registration requirements. In our view, this is a significant impediment to the efficient formation of capital for smaller companies, one that could easily be corrected by modernizing the existing prohibitions on advertising and general solicitation.
16 The AIM market had 513 IPOs through April 2006, compared with the NASDAQ’s 135. See generally Colleen O’Connor, London’s AIM Calls to US VC Community; Stateside seminars perfectly times to catch wave of Sarbox discontent, INVESTMENT DEALER’S DIGEST, Jan. 30, 2006.
A small company undertaking an IPO in the United States will pay three percent or more of the size of the offering to lawyers, accountants and advisers. It will also pay the typical rate of seven percent, or more, for an underwriter. Finally, the small company will watch as its stock trades at seven percent or more above the offering price on the first day (see Table 1, below).

Table 1: IPO Underpricing Across Different Markets

<table>
<thead>
<tr>
<th>Market</th>
<th>Median First-Day Return (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK – Main Market</td>
<td>4.4</td>
</tr>
<tr>
<td>UK – AIM</td>
<td>11.2</td>
</tr>
<tr>
<td>US – NYSE</td>
<td>5.1</td>
</tr>
<tr>
<td>US – NASDAQ</td>
<td>6.6</td>
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</tbody>
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The total charge after expenses and underpricing can average over seventeen percent of the value of the stock sold, as measured at the end of the first day of trading.

17 See Sean J. Griffith, *Spinning and Underpricing: A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings*, 69 BROOK L. REV. 583, 592 n.25 (2004) (discussing the debate surrounding the use of the seven percent underwriting fee standard, and adopts seven percent as the standard underwriter commission for the purposes of the article).


The median first-day return on a NASDAQ IPO represents the middle-range in the amount by which the initial offering price of an IPO is less than the actual market value, signified by its return after the first day of trading. This “underpricing” may be a means by which underwriters generate investor interest by offering the stock at a price under its actual market value, which will help these initial investors realize a short-term gain from the resulting price increase in the secondary market. Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 724-25 (2005).


19 This difference between a firm’s gain from the sale and the actual market value of what was sold is significant when considering the future return promised to shareholders. Consider the difference between a promised return of ten percent on an IPO with a market capitalization of $50 million. After fees and expenses, the company’s net gain would only be $45 million. With this reduced gain, the $5 million return promised to shareholders would require increasing the return from ten percent to eleven percent.
The high fees, the underwriting discount and the under-pricing of the shares are all due to the underwriting process mandated by existing SEC rules. The rules are well-known and deserve only a brief mention here. SEC rules break down the underwriting process into three periods: the pre-filing period, the waiting period, and the post-effective period. The periods are defined by four dates. When a company is “in registration” (usually thirty days before the filing of a registration statement) and until it files a registration statement with the SEC, the company is in the pre-filing period and cannot make offers or sales of its securities. From the filing of the registration statement until the SEC declares the statement “to be effective,” the company is in the waiting period and can make limited types of offers to sell but cannot close any sales. From the effective date until the end of the “distribution,” the company is in the post-effective or distribution period and can sell the stock if it delivers a formal selling document, the final prospectus, to purchasers.

Most IPOs are conducted as firm commitment offerings. A syndicate of investment banks underwrites the offering. The syndicate purchases the entire allotment of new shares and resells them to the public during the distribution period. One of the underwriters, the lead or book-running manager, will take the primary role in organizing the offering. The night before the distribution period begins, the issuing company and the lead underwriter will agree on the public offering price, and the formal underwriting agreement that prices the shares will be executed the following morning. The underwriter solicits views on price during the waiting period. Until 2005, general advertising solicitations were tightly controlled. Since 2005, underwriters, acting on behalf of issuers, can use a “free writing prospectus” exception to broadcast offers to the public in any media.

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21 GAO REPORT, supra note 3, at 75.
22 Id. at 75-76.
25 Id. The waiting period is the period between the filing of the registration statement and its effective date. Id. at 554.
26 Written offers, including electronic communications, outside those previously permitted by the Securities Act are allowed, provided certain conditions are met. Securities Offering Reform: Final Rule, 70 Fed. Reg. 44722, 44744 (2005) (adding the definition of a “free writing prospectus” to the Securities Act Rule 405).
A pricing variant that is much discussed and was used by Google is the Dutch auction offering. There is no fixed price. Investors place bids for a desired number of shares at or below a specified price. The issuer selects the highest price that will sell out the offering and all investors who had bid that price or higher pay the selected price. There have been high hopes by companies that Dutch auction offerings would limit the underpricing of the shares and companies would leave less “money on the table.” However, the results of the auctions, not popular with investment bankers, have been mixed.

Companies that cannot find investment banks willing to do a firm commitment underwriting are left with a less desirable alternative, the best efforts offer. The investment bank does not purchase and resell the securities, a dealer role, but instead acts as a selling agent, a broker, and receives a commission for each security sold. In a conditional best efforts offering, an all or nothing offering, the issuer promises to rescind all the

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28 Id., supra note 27, at 98.
29 Id.
30 See James Surowiecki, How To Do An IPO, SLATE, Dec. 9, 1999, http://www.slate.com/id/1004150 (stating that the Dutch auction is “a superior way of pricing an IPO because no one gets shares on the basis of who they know, and because it ensures that the company going public isn’t going to leave too much money on the table by going public at a lower price than the one the market was willing to pay”).
31 See generally Hurt, supra note 18, at 765 (although the author is referring to online auctions, Dutch auctions are similarly regarded by investment bankers). Further, as issuers generally choose an underwriter early in the IPO process, the underwriter will likely not counsel the issuer to investigate the possible benefits of the online IPO. Id. at 770.
32 The Google IPO cannot be considered representative of the value of the Dutch auction process due to its uniqueness as an issuing company. Hurt, supra note 27, at 435. Further, the criteria one values in a “successful” auction IPO is itself conflicting. While many consider an increase in share price from excessive demand to denote a successful offering, proponents of the auction process may consider the degree to which the initial offer price mirrors the market price as signifying a successful auction. Id. at 428. Hambrecht, a major U.S. supporter of the auction process, “considers an auction IPO with a first-day pop of 10% or more a failure.” Id.
33 Best efforts offerings are most common with more speculative securities or with new issuing companies. GAO REPORT, supra note 3, at 75–76.
34 The underwriter may agree either to only purchase as many shares as they can successfully resell, or act only as brokers and aid in finding willing investors. Id. at 75.
35 Thus, the underwriter assumes no financial risk for the sale of new shares as the issuing company retains ownership rights over these shares. Id. at 24 n.20.
sales if the offering is not sold out.\textsuperscript{36} Investors discount the price of the
shares to reflect the higher valuation risk, reflecting the investment bank’s
lack of confidence in the securities.

It is within the SEC rules for companies to do a direct public IPO
(or “DPO”), an offering by the company directly to the public without an
underwriter.\textsuperscript{37} Few are tried and many of those that are tried fail.\textsuperscript{38}
Investment banks argue that investors shy away from offerings that do not
have the certification of an underwriter who has backed the offering with its
reputation and exposure to liability for errant company claims. Moreover,
those companies whose securities do not meet the listing requirements of a
national securities exchange or the NASDAQ must register with all those
states in which stock will be sold.\textsuperscript{39} This can be a substantial burden for
some DPOs.\textsuperscript{40} Finally, the hostility of investment banks towards DPOs also
affects the willingness of the major players in the investment community to
invest robustly in DPOs; they cannot risk jeopardizing their ongoing
business relationships with the banks. Thus, for most issuers, a DPO is
currently only a financing option of last resort.\textsuperscript{41}

Firms have emerged that offer DPO expertise.\textsuperscript{42} Some will prepare
registration documents, hyperlink marketing programs, website
consultations and creation, and oversight of the registration process.\textsuperscript{43} At
issue is whether such experts in registered DPOs are underwriters or just
securities marketing specialists.\textsuperscript{44} Those experts that do registered DPOs
may be underwriters under the Securities Act of 1933 and be subject to the
Act’s Section 11 liability.\textsuperscript{45} If so, those experts must perform due diligence
similar to that undertaken by investment bank underwriters in firm

\begin{itemize}
\item \textsuperscript{36}STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS
414 (2005).
\item \textsuperscript{37}See Sjostrom, supra note 24, at 540–544. A DPO must either register with the SEC,
or qualify for an exemption under either Rule 504 (17 C.F.R. § 230.504 (2000)) or
Regulation A (17 C.F.R. §§ 230.251–263). Rule 504 and Regulation A companies are
exempted as “small offerings.” A Rule 504 offering is capped at $1 million and a Reg.
A offering at $5 million.
\item \textsuperscript{38}Sjostrom, supra note 24, at 581 (stating that of the 2,000 DPOs of companies from
1990 to 2001 only 156 still publicly trade).
\item \textsuperscript{39}Id. at 544 (stating that registration is required unless the company fits an exemption
within that state).
\item \textsuperscript{40}Id. at 544–545. The DPO issuer will likely have to register the offering or structure it
to meet the exemption requirements in the intended states for selling the offering, each
of which has their own individual blue sky laws that often lack uniformity in areas such
as registration requirements and exemptions.
\item \textsuperscript{41}Id. at 585.
\item \textsuperscript{42}Also known as “cyber middlemen.” Id. at 591.
\item \textsuperscript{43}Id.
\item \textsuperscript{44}These intermediaries do not typically have strong enough reputations with investors
to provide trusted assurances to the investor, nor is it clear whether these intermediaries
perform any investigations of their issuer clients. Id. at 592.
\item \textsuperscript{45}See id. at 594 n.27.
\end{itemize}
commitment underwritings to limit their liability exposure, and investors may similarly rely on these investigations. Since established investment banks have not chosen to offer these DPO services, however, the reputation and the solvency of the DPO experts is not equal to traditional underwriters.

II. THE AIM

The London Stock Exchange is successfully marketing a low cost public offering process to small companies, entitled the Alternative Investment Market ("AIM"). The AIM caters to companies in the micro to small cap universe, offering access and liquidity comparable to NASDAQ at a lower total cost to the issuer. Small companies can raise capital on the AIM with fees and underwriting charges that are thirty percent of those incurred in the United States markets. Under-pricing losses are less as well. Smaller offerings with a consideration of less than 2.5 million Euros may also qualify for an exemption from filing a prospectus, further eliminating associated costs when compared to a listing on the NASDAQ. Finally, the listing process takes only eight to twelve weeks, compared to the six to eight months required in the United States.

40 See id. at 594 n.29.
41 Further, these intermediaries may dispute whether their performance responsibilities fit the definition of an “underwriter,” and argue against Section 11 liability. Id.
43 The average market value for an AIM company was $71 million last year, compared with $1.2 billion on the NASDAQ. Edgar Ortega & Nandini Sukumar, London’s AIM snaps up small companies, SUNDAY TRIBUNE (Ireland), June 11, 2006, at B8.
44 The estimated expense to execute an IPO on the AIM is thirty percent less than on the NASDAQ. Charley Lax, PE Week Wire, http://www.grandbankscapital.com/news/pressrelease.cfm?news_item_id=578 (last visited Sept. 9, 2006). Further, the cost of maintaining a listing on the AIM is sixty percent less than maintaining a listing on the NASDAQ, due largely to SOX 404 compliance costs. Id.
45 See id.
The AIM market has limited listing requirements.\textsuperscript{55} There is no minimum share requirement, no trading record requirement, no shareholder approval requirement, and no minimum market capitalization requirement.\textsuperscript{56} In addition to a working capital report,\textsuperscript{57} only two years of audits are required and a report on internal financial controls. A listed company must have a “nominated advisor” and declare its working capital.\textsuperscript{58} The Nominated Advisor (“Nomad”) vouches for the company, determining its suitability for AIM, and will do due diligence, but the requirements are less stringent than those for a full listing.\textsuperscript{59} The Nomad’s certification provides the substitute for the underwriter’s certification in the United States.

Most of the AIM companies go public through a so-called private placement (it does not have the same meaning in the United States), in which a company’s shares are offered to a select group of institutional investors that include well known names in the United States: Fidelity, Goldman Sachs and Merrill Lynch.\textsuperscript{60}

The AIM market is booming. In 2005, the AIM had three hundred and thirty-five IPOs compared to NASDAQ’s thirty-five.\textsuperscript{61} The deal size comparisons are also telling. The average technology IPO deal size on the NASDAQ was $120 million, on the AIM it was $19 million.\textsuperscript{62} The AIM supported the smaller deals. AIM investors were willing to accept more risk, as the enterprise value was around six times revenue, as compared with the NASDAQ’s enterprise value of around five times revenue.\textsuperscript{63} The London market has successfully created a public offering market for small and micro cap companies. To remain competitive, the United States trading markets need to mount a successful competitor to this market.

III. WHAT COULD BE …

\textsuperscript{55} The main component of the listing requirements is the admission document. \textit{Id.} at 31, Table 2 (contains the complete list of requirements).
\textsuperscript{57} See generally \textit{LONDON STOCK EXCHANGE, supra} note 54, at 59 (details, purpose, and requirements of the working capital report).
\textsuperscript{58} \textit{Id.}
\textsuperscript{59} \textit{Id.} at 18–27.
\textsuperscript{61} These comparisons were drawn from data available at the websites of both the AIM and the NASDAQ. Monthly data for the AIM is available at http://www.londonstockexchange.com/en-gb/pricesnews/statistics/factsheets/aimmarketstats.htm. NASDAQ data may be found at http://www.nasdaq.com.
\textsuperscript{62} See \textit{id.}
\textsuperscript{63} See \textit{id.}
The AIM market suggests the obvious; the United States needs a more flexible system of public offerings. Small companies in the United States should be able to more easily go public with DPOs offered through the Internet. The goal would be an eBay style system for small companies. Run a Dutch auction for your shares on the Internet. Regulatory changes necessary to stimulate such a market would include:

1. Expanding the scope of federal pre-emption of state blue sky laws. Defining “covered securities” under Section 18 of the Securities Act of 1933 should include those companies traded on alternative trading markets such as the NASDAQ Bulletin Board.

2. Tighten the definition of underwriter under the 1933 Act to exclude securities marketing experts in registered DPOs unless those experts self-declare that they are underwriters. Those that self declare as underwriters are liable for a failure of due diligence (intentional complicity, recklessness, or negligence) if there are misleading statements or omissions in the offering materials.

3. Reduce the registration requirements for smaller companies that choose to trade on the alternative trading markets.
   a. Two years of audited financials, an identification of the principals, and a declaration of a business purpose should be enough to register. Companies could choose to offer more information or bind themselves to stronger disclosure obligations or internal control procedures.
   b. No form limits on Internet offerings or auctions. Internet offerings could start during the waiting period, with sales and/or auctions starting in the post-effective period. Sanctions for securities fraud (Rule 10b-5) would continue to apply.

The changes would give small companies an option of raising capital in our public markets at lower costs and in lower amounts.

IV. THE OBJECTIONS

The primary two objections to an easy, inexpensive method of auctioning stock of small companies on the Internet are, first, increased and unacceptable levels of promoter fraud, and, second, increased and

64 15 U.S.C. § 77 t (b)(1)(a) (2001). A covered security is one that listed or approved for listing on the NYSE (or an approved regional exchange) or a national market system security on the NASDAQ. Professor Sjostrom has a similar suggestion. Sjostrom, supra note 24, at 587–88.

65 Both small businesses and the Internet have each been associated with a high amount of fraudulent activity. Sjostrom, supra note 24, at 583. See also Arthur Levitt Jr., A Misguided Exemption, WALL ST. J., Jan. 27, 2006, at A8 (“Consider that these [small] companies are the ones most likely to have internal control problems, and least likely to have analysts, institutional investors and the media watching them.”); Steven Davidoff,
 unacceptable investor speculation. The first argument is the more serious of the two.

Small companies have been responsible for a large proportion of the instances of investor fraud. By allowing small companies to make Internet offerings will we be giving the green light to the scam artists? No doubt more will try. Better investor education and stronger enforcement efforts should make the increase in fraud bearable, however. Moreover, the increase in fraud will be offset by the increase in legitimate business activity stimulated by the reduced costs of raising capital for many of our most innovative and productive companies.

I also suspect that our fear of scams is overblown, supported by those who stand to lose the most from the new IPO methods—investment banks. Investment banks, just as brokers did when fixed commissions were nixed, may find that new profitable opportunities have increased, not decreased, and that their old business for the larger companies survives and flourishes.

Investors will use the Internet offerings and the subsequent trading in the IPO stock as speculative opportunities. There can be no doubt. Day traders will plumb the new stocks for speculative gains. It is a better alternative to casino gambling. Gambling funds directed into stocks have a socially useful side (in addition to entertainment value); casino gambling does not. I would much rather have those in our casinos and sports betting parlors direct their money into the stock market than keep the funds where they are.

V. CONCLUSION

The Internet has created an opportunity to allow our smaller companies to raise public capital in smaller amounts and at much lower
cost. We should take advantage of the new technology and not let our fears of an unknown scam potential stymie our efforts.