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The IPO Climate: In the Wake of Facebook, Are IPOs Really Broken?

BY DAVID B.H. MARTIN & FREDERICK J. KNECHT

David B.H. Martin and Frederick J. Knecht are partners in the Securities and Capital Markets practice of Covington & Burling LLP. Mr. Martin served previously at the U.S. Securities and Exchange Commission, including as Director of the Division of Corporation Finance. Contact: dmartin@cov.com or fknecht@cov.com.

IPOs are back in the news, but not for all of the right reasons. In the wake of Facebook, Inc.'s high-profile initial public offering (IPO), which has drawn adverse publicity on a number of fronts, there have been accompanying calls for overhaul or reform of the IPO regulatory system—again a convenient scapegoat. We think this furor is misplaced, and, in any event, talk of a drastic overhaul of IPO rules is not helpful.

In 2000, there were 446 IPOs completed in the U.S.; in 2011, that number had fallen to 110. Equities markets have proven exceptionally volatile since the beginning of the financial crisis, and among those companies that have undertaken IPOs during this period, the results have been mixed, with success harder to predict. More than half of IPOs launched from 2010 through the first half of 2011 either failed to price or priced below the initial filing range. Confidence in the equity capital markets, especially among retail investors, has been shaken. Some commentators have posited that we are witnessing the creation of a new generation of investors that does not (and may never) regard U.S. equities as their best long-term investment.

At the same time, private company CEOs and CFOs appear less enamored with IPOs than in the past. For many, the regulatory costs and complexities of being a U.S. public company are high and viewed as burdening smaller companies disproportionally. Moreover, many believe that shareholder pressures on public companies force them to put near-term revenue growth ahead of long-term strategy. While private companies still need ready access to capital, and IPOs remain the avenue to achieve that for some, prospective IPO candidates fear the economic costs, regulatory risks and potential loss of independence. In many cases, it has become more attractive to sell a company than to IPO it.

Recently, issues surrounding the Facebook IPO have led to renewed criticism of how IPOs are conducted and, among other things, the special role of investment banks—both as underwriters and producers of equity research. With the reputation of the investment banks put in renewed play by the financial crisis, they are easy targets both for those who believe issuers fail to get the full benefits of their IPOs and those who believe some or all investors are systematically disadvantaged. Much criticism of IPOs from Democrats is levied at Wall Street, and the ongoing effects of a financial crisis they blame largely on the big banks. Across the aisle, Republicans discredit the regulatory regime under which public companies operate—not only the Sarbanes-Oxley Act and its attendant accounting and disclosure rules but also the rules governing the IPO process itself. And recently, in a June 19 letter to Mary Schapiro, Chairman of the U.S. Securities and Exchange Commission (SEC), U.S. Rep. Darrell Issa (R-Calif.), writing on behalf of the House Oversight and Government Reform Committee and pointing to the Facebook IPO, argued that the restrictive regulatory structure under which IPOs are conducted, coupled with conflicts of interest to which underwriters are subject, results in a system in which institutional investors are routinely favored over both retail investors and the IPO issuer itself.

In the public dissection of the Facebook IPO and recent general criticisms of the IPO process, including of Rep. Issa's, we see possible momentum for a major review and potential alteration of the long-standing approach taken to the regulation and execution of IPOs in the U.S. But is the system broken and is fundamental change really warranted? And what are the risks of such change?

The Value of Underwriters

One of the recurring areas of attack is the role played by underwriters in the IPO process, and in particular their activities in marketing and pricing IPOs. Yet, underwriters are critical to the success of most IPOs and the smooth functioning of capital markets. The vast majority of companies undertaking IPOs are not well known to the investing public before their IPOs. Unlike a Facebook or a Google, most have not achieved a following among public company investors and research analysts while still privately held, and most are not the subject of widespread media interest. In choosing underwriters, the more typical IPO candidate is seeking expert advisors to aid it in achieving several goals: (*i*) help the company ready itself to be a public company; (*ii*) market the company to potential investors; (*iii*) place the company's shares with a broad, stable group of long-term shareholders; and (*iv*) ensure that an aftermarket for the shares develops that is liquid and strong.

Taking a typical private company—relatively unknown to the market and often lacking the corporate structures, management and practices of a public company—from the earliest IPO planning stages through to successful completion is a complex and lengthy process. Underwriters engage in that process without any practical certainty that it will be completed and often without any binding commitment from the issuer to stick with them. The compensation of the underwriters can be generous, but it comes only at the end, as a percentage of the proceeds of the IPO, if successful. In exchange, the underwriters take on significant economic risk as well as the potential for substantial legal liability to investors who purchase the shares.

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Investors look to the underwriters as well, because the regulatory framework governing IPOs places underwriters in the position of "gatekeepers" for the capital markets. Each IPO investor is entitled to receive a written prospectus. That prospectus must contain all of the information about the company that a reasonable investor would regard as material in deciding to purchase the company's shares. The company has direct liability to investors for the quality of the prospectus disclosure, but the Securities Act of 1933 also makes the underwriters responsible for the prospectus. The underwriters participate in the preparation of the prospectus and undertake a "due diligence" investigation of the issuer. If that investigation is inadequate in scope or substance, and the prospectus disclosure is found to be materially inaccurate or incomplete, the underwriters can be directly liable to investors for their losses. Moreover, if the issuer has become insolvent, the underwriters are likely to be left holding the bag alone.

Risk Allocation in IPOs

In his June letter to the SEC, Rep. Issa maintains that this liability structure is used by underwriters to force issuers to accept prices for their shares that are too low (and that the foregone value is steered by underwriters to institutional investors they favor). He believes that underwriters, seeking to protect themselves against a later decline in the market price of the stock and potential investor lawsuits that could follow, deliberately underprice IPOs even though that results in less proceeds for the issuer (and less compensation for themselves). Notably, however, the risks of IPOs are not primarily borne by the issuer or underwriters but by the investors. And, investors in IPOs are at much greater risk than those who invest in shares of already public companies. IPO investors hope for a greater reward by investing in IPOs, and they are willing to take on greater uncertainty, but for that they demand a pricing discount. In reality, such investors, especially the largest institutional investors, have substantial leverage in the IPO pricing process. As underwriters attempt to build a book of orders for IPO stock, the investors indicate specifically how much they are willing to purchase at various price points, and at certain price points will have no interest at all. Rep. Issa maintains that underwriters can "dictate" IPO share prices to the market, and that market forces of supply and demand can be largely ignored by them, but we believe that is rarely the case.

We do agree that litigation risk stemming from the Securities Act's liability structure accounts for some downward pressure by underwriters on IPO prices. However, over time and across multiple offerings, underwriters know with certainty that they will face legal losses, and pricing discounts to reflect that risk are a fair result. Any single deal may prove to be liability-free, but it is exceptionally difficult to identify such deals other than with the benefit of hindsight. At the same time, litigation risk (along with reputational risk) is what primarily drives carefulness and caution by underwriters in the process. It encourages thoroughness and accuracy in due diligence and disclosure, and it discourages the over-selling of an issuer or its future prospects. It drives both issuers and underwriters to include a balanced discussion of risks in the IPO prospectus, and it leads underwriters to be more conservative than they otherwise might be in what they allow their sales forces to say to prospective investors.

Rep. Issa points to the 2004 IPO of Google, Inc. to suggest that a market-based, "Dutch auction" approach to IPO pricing and distribution should be mandated by the SEC. He believes such an approach allows issuers to avoid what he describes as the "large tax on their value at their outset" that results from the current pricing practices of underwriters. Unfortunately, most issuers are not in the position of Google at the time of their IPOs. They are much more likely than Google to need the marketing expertise of underwriters and the effort of their sales forces to place their shares successfully. Moreover, most companies have a specific desire to have their shares come to rest with long-term, institutional holders. They are reluctant to have their shares allotted to the highest bidders without regard to what type of shareholders they may be, and they are necessarily reliant at least in part on the underwriters' relationships, built over time, with the types of institutional holders considered most desirable. A Dutch auction approach might yield higher proceeds to issuers on average, but that would represent the shifting of more risk from issuers to investors coupled with a loss of control over who those investors are. Notwithstanding the use by Google of a Dutch auction for its IPO and the continued availability of auctions as an option, the vast majority of IPO candidates since Google have elected not to use it. Against these facts, it is curious, particularly from the Republican side, to consider a government mandate for such a specialized sales process which clearly is not the right one for all.

Special Position of Research Analysts

Criticism of the IPO process has also focused recently on the specific role of research analysts. Research analysts provide a much valued service to their investor clients by providing analytical insights into companies, industries and markets. Their financial analyses tend to be complex and are based on numerous assumptions. Their estimates of future company earnings can be important to investment decision-making by their clients. On the other hand, such analyses and estimates must be understood for what they are, including the inherent limits to their reliability. Over the last decade, research analysts have come under sharp criticism. The court-ordered research settlement of 2003 forced a disassociation of the investment banking and research arms of underwriters. Ensuing regulations, now embodied mainly in FINRA Rule 2711, limit the role of research analysts in investment banking transactions. However, questions still persist about the proper role of analysts employed by the underwriters in IPOs. Can the analyst play a marketing role for the offering on behalf of the issuer? Does the analyst have a role in educating investors about the issuer, and if so is that a process by which information from the issuer reaches certain investors? Does the analyst face a basic conflict of interest between investors and the issuer?

Two principal themes must be kept in mind in considering the roles of research and research analysts in offerings. First, the regulatory framework under which securities offerings are conducted is premised on the idea that investors receive a written prospectus that must contain all of the material company information they may reasonably require for their investment decisions. That regulatory framework restricts the degree to which other written materials, including research reports, may be provided to investors in relation to offerings (both by imposing specific prohibitions and, where not prohibited, imposing potential liability for content). Second, the regulatory framework establishes conduct rules for research analysts and the underwriting firms they work for that are intended to help ensure that analysts are shielded from conflicts of interest and the undue influence of issuers and investment bankers. These rules are numerous and include requirements that analysts personally certify as to their views, refrain from pitching investment banking business to companies or promising them favorable research, limit their interactions with investment bankers and avoid engaging in the marketing of IPOs or other offerings at their direction. The rules are intended to ensure that research analysts serve the interests of investors primarily, rather than the companies they cover or the investment bankers at their firms.

Under the umbrella of these rules, analysts are free to speak with their investor clients about IPO issuers, including during the offering. They may discuss their views of the company and its prospects, including estimates of future earnings, and they may comment on the merits of the offering. Historically, there were strict blackout periods on the issuance of written research reports around the time of offerings, as well as rules under which any research reports distributed in connection with offerings could be deemed to be illegal prospectuses.

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Under the recent Jumpstart Our Business Startups Act (JOBS Act) analysts are now permitted to publish research reports on emerging growth companies (IPO issuers having less than $1 billion in annual revenue) at any time before, during or after their IPOs. While this could lead to a practice of issuing research on a company at the same time its IPO is being marketed to investors, developing practice suggests that underwriters may voluntarily restrict themselves in the issuance of research reports until after the IPO is completed, mainly for liability reasons.

In any event, analysts employed by underwriters have never been obligated to issue research reports nor must they inform investors of their views. Moreover, if they do decide to share their views with investors or issue reports, they are not required to do so equally with all investors. There are a number of reasons why this makes sense. First, their analyses, views and reports are proprietary to them and their firms, and investors compensate the firms for access to the analysts' work. If analysts were obliged to disseminate their analyses broadly, the business model for research would not remain viable. Second, analysts and their firms need to be able to limit access to research to those investors for whom they determine it is appropriate. There is potential liability for firms in providing their research to investors, particularly those who may lack the sophistication to understand the analysis or who by their nature may place undue reliance on it. In particular, a research analyst's forward-looking earnings estimates and the complex models and key assumptions on which they are based are generally considered appropriate for more sophisticated, typically institutional, investors. Such investors are better able to understand how the analyst's financial models are constructed and the degree to which variables and inherent uncertainties affect them.

Financial Projections & Analysts' Earnings Estimates

Rep. Issa, in his letter to the SEC, criticizes the Facebook IPO on the grounds, among others, that research analysts employed by the underwriters may have disclosed their earnings estimates for the company to some, but not all, of the investors and then further disclosed revisions they made to those estimates as additional information became available from the company. This criticism ignores the fact that the views of the research analysts are their proprietary work product which they have no obligation to share beyond their own investor clients. More importantly, it fails to recognize that, as a policy matter, it likely would be completely inappropriate to encourage all investors to rely on an analyst's earnings estimates. There is also nothing improper about analysts adjusting their views, positively or negatively, during the course of an offering as new or additional information becomes available. Indeed, it would seem to make perfect sense and good policy that they should do so. Having done so, it would not be in the interest of any investors, or the market as a whole, to impede analysts from updating those investors with whom they may have shared their earlier views.

Rep. Issa seems to believe that underwriters would allow a much broader dissemination of their analysts' views if only such views were accorded a safe harbor from liability, and that such a result would be beneficial to markets. He points to Rule 175 under the Securities Act as flawed because, while it provides a safe harbor for forward-looking statements, it requires that such statements be made on a reasonable basis and in good faith, subjective elements he believes open the door to litigation. He also notes that § 27A of the Securities Act provides reasonable protections against liability for forward-looking statements but for companies which are already public, not IPOs.

However, the SEC has viewed financial projections in the IPO context, including those prepared for internal use by the issuer, with caution—in our view, rightly. The SEC specifically considered and declined to amend the safe harbor rule under § 27A to apply to IPOs when it adopted many other securities offering reforms in 2005. At that time, the SEC noted that IPO issuers are untested, and, therefore, that investors have a very limited basis on which to judge the reasonableness of the assumptions on which financial projections for them may be based. The SEC has deliberately avoided encouraging the use of financial projections in IPOs because of the potential inappropriateness of such information in that context. As a result, financial projections, even if available, are not required as a matter of form to be included in prospectuses; and, in most cases, companies and their legal counsel determine that the omission of such projections from prospectuses is not material to investors because the projections are too uncertain to be properly relied upon by investors. At the same time, a prospectus must discuss the company's business and financial performance, including the company's plans for the future, the competitive and other pressures it faces, and the risks that could affect its financial results.

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We think this reflects an appropriate and logical balance, and we do not believe that a regulatory regime that either encourages or requires the dissemination of issuer financial projections or research analysts' estimates would be in the best interest of investors. Evidence supports the idea that research analysts' estimates in IPOs are subject to inherent unreliability. The Wall Street Journal recently reported that analysts have a poor track record predicting the earnings of newly public companies, with their estimates for a company's first earnings report after going public off by an average of 54% for IPOs since 2010. Moreover, even if Rep. Issa had his way—*i.e.*, a liability safe harbor for research reports or analysts' statements in IPOs without Rule 175's subjective elements—it is not at all clear that analysts or their firms would seek to disseminate research views more broadly. This is so because no research safe harbor, including any that might be created by altering Rule 174 or § 27A, is likely to cover knowingly false statements, a charge which would remain too easy to make, if only for its potential settlement value, against any estimates or projections that with hindsight appear overly optimistic.

Institutional vs. Retail Investors

Lastly, concerns have been raised about the pole position that institutional investors enjoy in IPOs, and in particular the access such investors get to company management and research analysts in the process. This criticism too seems out of touch. It is true that issuers and underwriters cater to the needs of institutional investors during IPOs. They are the ones that get invited to road show presentations by company management, and they seek out and get the views of research analysts whose views they trust. They typically do more work evaluating issuers, analyzing their financials, estimating their valuations and weighing an investment in them against other investment opportunities. Importantly, they are often investing money on behalf of others (often individuals) and have responsibilities to them for the investments. Because of their role, and their knowledge, they have substantial leverage in driving company valuations and the pricing of IPOs. This is generally good for noninstitutional investors participating in the offerings, as well as for the capital markets as a whole.

Much of the regulatory regime governing securities offerings is premised on the importance of institutional investors in testing and evaluating investment opportunities. Institutional investors are allowed to participate in private financing rounds not open to retail investors. The newly enacted JOBS Act allows prospective IPO issuers to meet with institutional investors (but not retail investors) at any time, even before filing a registration statement, to preview the IPO and assess the institutions' potential interest in it. These rules recognize that institutional investors may well need greater access to company management in IPOs than do retail investors and that such access helps fledgling issuers as much as it helps the institutional investors. Not only are such investors better equipped to analyze a prospective issuer and its financial condition, but they also make up the most stable investor base a company desires. This is largely because they are much better positioned to weather the risks of an investment in an IPO company, and underwriters try to direct IPO shares to those institutions that understand the company best and who evidence an intention to be long-term holders. That they get more individualized treatment in an IPO, enjoy greater access to company management, and have a favored position under securities laws reflects a recognition of the fact that the efficiency, liquidity and safety of the markets are dependent on their dominant role. And, it reflects the fact that an IPO is a particularly risky type of investment not suitable for all investors.

A Cautious Approach to Regulatory "Reform"

Legislators and regulators should be cautious in considering wholesale changes to the securities laws and regulations governing IPOs. The current regulatory framework consists of a complex and well-established web of interdependent rules developed incrementally over time. Under those rules, issuers, underwriters, and investors play critical roles that reflect a balancing of interests and a well-trod allocation of risks. Periodic modifications to these rules have been made, driven both by investor protection objectives as well as the practical needs of issuers, underwriters and investors. Generally, the SEC has undertaken rule changes with care, and after extensive consultation with all market constituencies. In contemplating further changes, the risk of unintended consequences and the potential for erosion rather than enhancement of investor confidence should always be kept in mind. We believe that while the IPO process is certainly not perfect, it works well in most cases to balance the competing interests of companies and their investors, both institutional and retail, in the face of the inherent uncertainties and risks involved in such offerings. We also believe that market forces drive company valuations in IPOs with about as much efficiency and accuracy as can reasonably be expected given these same inherent uncertainties and risks.

Unhappiness with one or a few IPOs—including Facebook's—because of perceptions, after the fact, that money is sometimes left on the table by issuers or sometimes lost by investors, does not mean that the IPO market, or the regulatory framework on which it is based, is fundamentally flawed. Rather, it may be good proof that things are working as they should.