Testimony of Joel H. Trotter
Partner, Latham & Watkins LLP

Before the U.S. Senate Committee on Banking, Housing & Urban Affairs
Subcommittee on Securities, Insurance, and Investment

"Examining the IPO Process: Is It Working for Ordinary Investors?"

Washington, D.C.

June 20, 2012

✯

Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, thank you for inviting me to appear before you today. I appreciate all of the hard work that each of you and the members of your staff give in service of our nation.

Benefits of a Favorable IPO Environment

I have been a securities lawyer for 17 years, and it's fair to say that initial public offerings (IPOs) have been at the core of my practice for nearly all of my career. In the last five years, for example, I have worked on most of the IPOs (approximately 110 of them) on which my firm advised. Recently, I had the honor to serve on the IPO Task Force, whose recommendations gave rise to Title I of the recently enacted Jumpstart Our Business Startups Act, which passed Congress with overwhelming bipartisan support. So, I am steeped in the law and lore of IPOs, and that's the perspective I bring to you today.

In my view, the best way to make the IPO process work for ordinary investors is to ensure that IPOs can happen in the first place. It's important to keep in mind that private companies have two alternative paths for providing liquidity to their early-stage investors: they can choose to pursue either an IPO or a sale of the company. Some companies might try both temporarily, using a dual-track process, but ultimately they have to choose one or the other.

An inhospitable IPO environment sends more early-stage companies toward a sale process and away from the IPO alternative. In recent years, overall IPO activity has fallen off dramatically in the United States, and smaller IPOs have all but disappeared. Over the same period, "the prevalence of IPOs versus acquisitions of emerging growth companies has undergone a stunning reversal," as the IPO Task Force noted last October in its report.[1] In the most recent decade, the vast majority of private company liquidity events have occurred by means of a company sale rather than an IPO. In contrast, during the decade prior to that, IPOs easily represented the majority of private company liquidity events.

This trend warrants our attention because IPOs play an important role in job growth:

- from 1980 to 2005, companies less than five years old accounted for all net job growth in the United States, according to an IHS Global Insight study;
- 92 percent of job growth occurs after a company's IPO, mostly within the first five years post-IPO, according to the same study; and
- companies that went public since 2006 reported an average of 86 percent job growth post-IPO, according to a survey conducted by the IPO Task Force.

Many of today's household-name companies emerged decades ago as fledgling startups. These companies were, by today's standards, small and untested at the time of their IPOs. And yet some of these now-dominant companies have become so large that entire metropolitan regions have built up around them. Around the nation, these thriving cityscapes of today would look altogether different if those fledgling startups of yesterday had pursued a company sale in an M&A transaction rather than pursuing independent growth by raising capital in an IPO.

So far, so good. A more robust IPO market will help investment capital by providing more liquidity alternatives for early-stage investors. And more IPOs will have a positive effect on innovation and job creation. How, then, can we help the IPO process?

---

[1] IPO Task Force, "Rebuilding the IPO On-Ramp: Putting Emerging Growth Companies and the Job Market Back

IPO On-Ramp (Title I of the JOBS Act)

The JOBS Act is an important step in helping the IPO process work better. Title I of the JOBS Act contains the IPO on-ramp provisions implementing the recommendations of the IPO Task Force. These provisions make several important changes to the IPO process for companies that qualify as emerging growth companies. For these companies, Title I of the JOBS Act:

- makes it easier to go public and provides significant cost savings in the IPO process;
- permits them to engage in pre-IPO discussions to gauge investor interest before committing resources to undertake a costly IPO process;
- enables them to begin the SEC registration process confidentially, rather than revealing their most sensitive proprietary information many months before a possible IPO that ultimately may not even occur;
- permits emerging growth companies to present streamlined financial statements using an approach that the SEC previously adopted for smaller reporting companies; and
- provides a limited transitional period of one to five years, depending on the size of the company, when they may defer compliance with the more costly regulatory requirements that apply to public companies.

Based on a survey of CEOs of pre- and post-IPO companies, the IPO Task Force estimated that going public costs approximately $2.5 million and that remaining public costs approximately $1.5 million annually. Based on survey data and interviews, we estimated that the accommodations in the IPO on-ramp could save companies 30 to 50 percent of those costs.

The accommodations in Title I of the JOBS Act apply to any issuer that qualifies as an "emerging growth company" under the statute. An emerging growth company is an issuer with less than $1 billion in annual revenue for its most recently completed fiscal year. A company will cease to qualify as an emerging growth company in one to five years, depending on the size of the company. Specifically, emerging growth company status terminates upon the earliest of four milestones:

- the company becomes a "large accelerated filer" under the existing SEC definition (requiring a public float of $700 million at the end of its second fiscal quarter, twelve months of SEC registration and at least one annual report on file);
- the company ends a fiscal year with $1 billion or more in revenue;
- the company issues more than $1 billion in non-convertible debt securities over any three-year period; and
- the fiscal year-end after the fifth anniversary of the IPO pricing date.

With this definition in mind, I will summarize some of the principal accommodations that the IPO on-ramp provides to emerging growth companies:

(1) Testing the waters. — Section 105(c) of the JOBS Act permits emerging growth companies to engage in pre-IPO discussions with institutional investors to determine whether the company has a good chance of completing a successful offering. Before the JOBS Act, prior restrictions prevented issuers from communicating with potential investors in advance of filing a registration statement. Now, emerging growth companies may engage in discussions to test the waters with institutional investors before deciding whether to commit the time, effort and resources necessary to pursue an IPO process. In the interest of investor protection, the JOBS Act requires companies using this process to deliver a copy of the statutory prospectus to each investor in the IPO before anyone can purchase shares in the offering.

By permitting emerging growth companies to test the waters, the JOBS Act fixes what some practitioners might call a "glitch" under prior law. Before the JOBS Act, a company engaging in a private placement to accredited investors could make an unlimited number of offers, to dozens or even hundreds of prospective investors, and ultimately sell the securities without ever providing those investors with any statutory disclosure. In contrast, the communications restrictions in the IPO process before the JOBS Act were much more restrictive in how issuers could communicate with investors — so restrictive, in fact, that many companies

would have difficulty determining whether they could expect sufficient investor interest to complete a successful IPO. This result was not only oddly incongruous but tended to stifle capital formation by inhibiting companies contemplating an IPO. On the one hand, the company could make an unlimited number of offers in an unregulated private placement to accredited investors with no prescribed disclosure. On the other hand, in the heavily regulated context of an IPO, an issuer previously could not have engaged in any pre-filing offers of any kind, even to super-heavyweight institutional investors.[2] The JOBS Act fixes that by permitting emerging growth companies to test the waters with institutional investors so that an emerging growth company can better determine the actual feasibility of an IPO before embarking on the process.

(2) Confidential submission. — Section 106(a) of the JOBS Act enables emerging growth companies to begin SEC registration on a confidential basis. This follows the SEC's historical accommodation accorded to foreign private issuers and, for emerging growth companies, represents a meaningful change by removing a powerful disincentive for an emerging growth company to pursue an IPO process. Now, an issuer that is an emerging growth company may begin the months-long SEC registration process while deferring until later in the IPO process competitors' access to proprietary business and financial information of the issuer. Companies using this alternative can now advance to the point where they have a much better ability to predict, based on market conditions and other vagaries of attempting to go public, whether they can complete a successful IPO before publicly disclosing their confidential information. In the interest of investor protection, emerging growth companies must publicly file their original confidential submission to the SEC, plus all amendments resulting from the

---

[2] Securities Act Rule 163 allows well-known seasoned issuers to make pre-filing offers, but that rule does not apply to IPO issuers and, in any event, contains its own so-called "glitch" that restricts issuers from enlisting their bankers' assistance to test the waters with prospective investors. Securities Act Rule 163(c); *cf.* Release No. 33-9098 (proposing to correct the glitch in Rule 163(c) by allowing well-known seasoned issuers to use underwriters to help "assess the level of investor interest in their securities before filing a registration statement").

confidential SEC review, at least 21 days before conducting a traditional road show process for the offering. As a result — unlike in the SEC's confidential process historically accorded to foreign private issuers — investors and other interested parties will have immediate web-based access to the complete submission and amendment history, including the initial draft of the registration statement and each iteration in the nonpublic review process, approximately one month before the issuer sells a single share to any investor in the IPO.

(3) Financial statements. — Section 102(b) of the JOBS Act allows emerging growth companies to present two years, rather than three years, of audited financial statements in their IPO registration statement. This accommodation follows the framework that the SEC adopted for smaller reporting companies, subject to a three-year transition to the traditional approach post-IPO. In each future year after the IPO, an emerging growth company that used the accommodation for financial statements would add one additional year so that, after three years, the emerging growth company would present three years of audited financial statements plus two years of selected financial data. By using the smaller reporting company framework available under existing law, this provision of the JOBS Act reflects the balance between capital formation and investor protection that the SEC previously struck when it adopted the scaled disclosure requirements that apply to smaller reporting companies.

(4) On-ramp transition period. — Title I of the JOBS Act provides a regulatory transitional period of one to five years, depending on the size of the company, when emerging growth companies may defer the more costly requirements that apply to public companies. Like other provisions of Title I, the transition period builds on existing SEC requirements. Under prior SEC rules, for example, all newly public companies, regardless of their size, benefited from a transition period of up to two years (until their second post-IPO annual report) before needing an

outside audit of their internal controls under Section 404(b) of the Sarbanes Oxley Act. Title I of the JOBS Act builds on this on-ramp concept by adding additional accommodations to the on-ramp period and by scaling the requirements to the size of the affected company rather than using a one-size-fits-all approach that would treat all companies the same regardless of their size.

IPO On-Ramp Elements

The on-ramp transition period applies as long as the issuer qualifies as an emerging growth company. Smaller companies will have more time to achieve full compliance, while larger companies will have less time. In any event, the transition period would conclude no later than the fiscal year-end after the fifth anniversary of an emerging growth company's IPO. At that point, the company must fully comply with the traditional regulatory requirements that apply broadly to all public companies.

During the transition period, an emerging growth company may:

- defer the outside audit of internal control as required under Section 404(b);[3]
- follow streamlined executive compensation disclosure modeled on existing requirements under the SEC's smaller reporting company rules (which, though streamlined, still require "clear, concise and understandable disclosure of all . . . compensation" of the top executives);[4]
- defer compliance with the Dodd-Frank executive compensation requirements to hold shareholder advisory votes (say-on-pay, say-on-pay-frequency and say-on-golden-parachutes) as well as additional compensation disclosure requirements (the pay-for-performance graph and CEO pay ratio disclosure);[5]
- defer compliance with new or revised financial accounting standards until those standards also apply to private companies;[6] and

---

[3] JOBS Act § 103.

[4] JOBS Act § 102(c).

[5] JOBS Act § 102(a).

[6] JOBS Act § 102(b). On occasion, new or revised accounting standards provide private companies with more lead time for compliance than public companies receive. This can occur with more complex standards that require significant data gathering or additional compliance personnel. In those cases, emerging growth companies may

- benefit from an exemption from any future rules of the Public Company Accounting Oversight Board mandating audit firm rotation or an expanded narrative audit report, called auditor discussion and analysis.[7]

Disclosure vs. Merit Regulation

As you can see, I believe that the JOBS Act's measured reforms will help the IPO process. But is the JOBS Act enough? Are additional changes warranted?

In addressing these questions, I believe it is important to remember how the Congress approached the issue of securities regulation almost eighty years ago when it enacted the Securities Act of 1933. Congress made disclosure the bedrock of our securities regulatory system. But Congress took a very specific approach to disclosure — one that has remained a key feature of our securities laws. In particular, Congress has sought to mandate disclosure of material information rather than attempting to pass on the merits of particular securities.

We find this approach reflected in the history and the text of the Securities Act:

- President Roosevelt specifically called for a disclosure regime rather than merit regulation: "The federal government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn a profit." Instead, Roosevelt envisioned that "every issue of new securities . . . shall be accompanied by full publicity and information."[8]

- Felix Frankfurter, one of the architects of the Securities Act, explained that "Unlike the theory on which state blue sky laws are based, the federal Securities Act does not place the government's imprimatur upon securities." The Securities

---

follow the longer, private company phase-in period. Alternatively, emerging growth companies may irrevocably elect to follow the shorter phase-in periods that apply to all other public companies. JOBS Act § 107(b).

[7] The PCAOB recently issued controversial concept releases on the subjects of whether the PCAOB should mandate audit firm rotation and an expanded narrative, called auditor discussion and analysis, that would appear as part of any financial statement audit. If the PCAOB decides to adopt rules regarding either of these requirements, EGCs will be exempt from those rules. In addition, no other new rule that the PCAOB may adopt in the future will apply to an EGC unless the SEC determines that the new PCAOB rule is "necessary or appropriate in the public interest," after considering investor protection and "whether the action will promote efficiency, competition and capital formation."

[8] H.R. Rep. No. 85, 73d Cong., 1st Sess. at 1-2 (1933).

Act, he said, is "designed merely to secure essential facts for the investor, not to substitute the government's judgment for his own."[9]

- The preamble of the Securities Act specifically reflects this approach, stating that the statute's purpose is to provide "full and fair disclosure of the character of securities."
- Merit regulation focuses principally on investor protection, whereas a disclosure-based approach balances investor protection and capital formation. Section 2(b) of the Securities Act reflects that balanced approach by requiring the SEC, whenever the agency considers whether rulemaking activity is "necessary or appropriate in the public interest," to consider, "in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."

My mentor and former partner, John Huber, previously served as Director of the Division of Corporation Finance at the SEC. He used a memorable anecdote to teach me the difference between merit regulation and a disclosure regime. Early in his career, John worked at a state securities commission. Staffers at the commission were proud of having refused to approve the common stock of a company whose name everyone in this room would recognize. The state securities commission had objected to the level of the CEO's compensation and therefore refused to permit the company to sell its stock to residents of that state. "What was the IPO price?" John asked. Answer: $22.00 per share. "Well," he responded, "the stock is now trading at $60.00 per share, so how exactly did we help investors in our state by preventing them from buying at $22.00?"

Disclosure in the IPO Process

That nicely sums up merit regulation. We can see why Felix Frankfurter emphasized that the Securities Act would merely "secure essential facts for the investor" rather than placing the government in the position of making investment decisions. This brings us to another issue: what are the essential facts for the investor?

---

[9] Felix Frankfurter, "The Federal Securities Act: II," Fortune (Aug. 1933).

Again, I return to core principles of our securities laws. We require disclosure of all information that is "material."

The federal securities laws contain a matrix of antifraud provisions designed to promote accurate and complete disclosure by imposing liability on material misstatements or omissions in connection with the purchase or sale of a security. In the landmark case of *TSC Industries v. Northway*, a unanimous Supreme Court established the fundamental test of materiality. The Court held that a fact is material if there is a substantial likelihood that a reasonable investor would consider the fact important in deciding whether or not purchase or sell a security. Moreover, the Supreme Court explained, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information available."[10]

If you have picked up an IPO prospectus recently, you may wonder whether we have drifted very far from the guiding principle of disclosing material information. An IPO prospectus today is a lengthy and detailed disclosure document often running as much as 200 or more pages in which the issuer provides:

- detailed narrative descriptions of the business, the company's executive management team and board of directors;
- risk factors identifying key risks relating to the company and the offering;
- audited financial statements and footnotes;
- MD&A disclosure providing a narrative description of management's perspective on the financial statements, including known trends and uncertainties (together with the financial statements, this narrative usually occupies almost half of the page count in the prospectus); and
- detailed disclosures on many other topics, including executive compensation, related party transactions, principal stockholders, description of the offered

[10] *TSC Industries v. Northway*, 426 U.S. 438, 449 (1976).

> securities, underwriting arrangements and other types of details required under SEC rules.

All of these are good and useful topics. But it can be hard to resist the temptation to add just a few more sentences here and a paragraph or two there, with the end result that the disclosure becomes impressive for its heft rather than for being clear and insightful. Brevity may be the soul of wit, but it is rarely the hallmark of an IPO prospectus.

The SEC's Advisory Committee on Improvements to Financial Reporting recognized this problem when it identified an "overly broad application of the concept of materiality and misinterpretations of the existing guidance regarding materiality."[11] Or, in the words of a unanimous Supreme Court, "Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good." An unduly low materiality standard, warned the Court, will bury investors in an avalanche of trivia:

> "If the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information — a result that is hardly conducive to informed decisionmaking."[12]

A balanced and reasonable approach to materiality is critical to the success of a disclosure-based regulatory regime. To be sure, our modern securities markets have changed in ways that would have seemed inconceivable to President Roosevelt and the Members of the 73rd Congress who enacted the Securities Act of 1933. But I respectfully submit that a fundamental principle that guided them has served our nation well for the last eight decades of securities regulation — disclosure of the "essential facts for the investor," focusing on what is truly

---

[11] Final Report of the Advisory Committee on Improvements to Financial Reporting (Aug. 1, 2008), at 76.

[12] *TSC Industries*, 426 U.S. at 448-49.

material information. That principle continues to serve individual investors best, even as the nature of the securities markets changes.

Risk and Reward

I would like to conclude with one additional thought. It is a fact of economic life that not all IPOs succeed. Any commercial enterprise that can earn a profit can also earn a loss. That's part of the tradeoff between risk and reward. IPO stocks can be very rewarding over the long term, but that necessitates investment risk, and that in turn brings the possibility of loss.

In other words, IPOs are potentially rewarding investments that carry corresponding risk. Like any business, a newly public company may or may not make money for its investors. That is why the cover page of every IPO prospectus says, "This is our initial public offering, and no public market currently exists for our common stock." That is why every IPO prospectus contains many pages of detailed risk factors regarding the company and the offering.

SEC Commissioner Daniel Gallagher recently underscored the need for capital markets that offer both transparency and the opportunity to put investment capital at risk:

> "When we consider proposed regulation, and the economic policy context in which we operate, we must think increasingly consciously not only of the protections we hope to give investors, but of the incentives and disincentives we create for capital formation itself in our public markets. Fair, transparent, and deep capital markets are good. Risk-free capital markets have no future. Were we somehow to create one, it wouldn't offer opportunity enough to attract either companies to list or investors, who would do just as well in savings accounts or Treasury bills."[13]

Thank you. It has been a pleasure to be here with you this morning. For reasons I hope you understand, I cannot discuss any specific IPOs and am unable to comment on any proposed regulatory changes. Otherwise, I welcome any questions you may have.

---

[13] Daniel M. Gallagher, "Remarks before AusBiotech" (May 1, 2012).