Testimony of

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Chairman Reed, Ranking Member Crapo, and members of the Subcommittee, I want to thank you for inviting me to testify. My name is Jay R. Ritter, and I am the Cordell Professor of Finance at the University of Florida's Warrington College of Business Administration. I have been studying the initial public offering (IPO) market for over three decades, and I have published dozens of peer-reviewed articles on the topic. I have consulted with private companies, government organizations, and law firms on IPO-related matters.

I will first give some general remarks on the reasons for the low level of U.S. IPO volume this decade and the implications for job creation and economic growth, and then make some suggestions on the specific bills that the Senate is considering.

First, there is no doubt that fewer American companies have been going public since the tech stock bubble burst in 2000, and the drop is particularly pronounced for small companies. During 1980-2000, an average of 165 companies with less than $50 million in inflation-adjusted annual sales went public each year, but in 2001-2011, the average has fallen by more than 80%, to only 29 small firm IPOs per year. The patterns are illustrated in Figure 1.

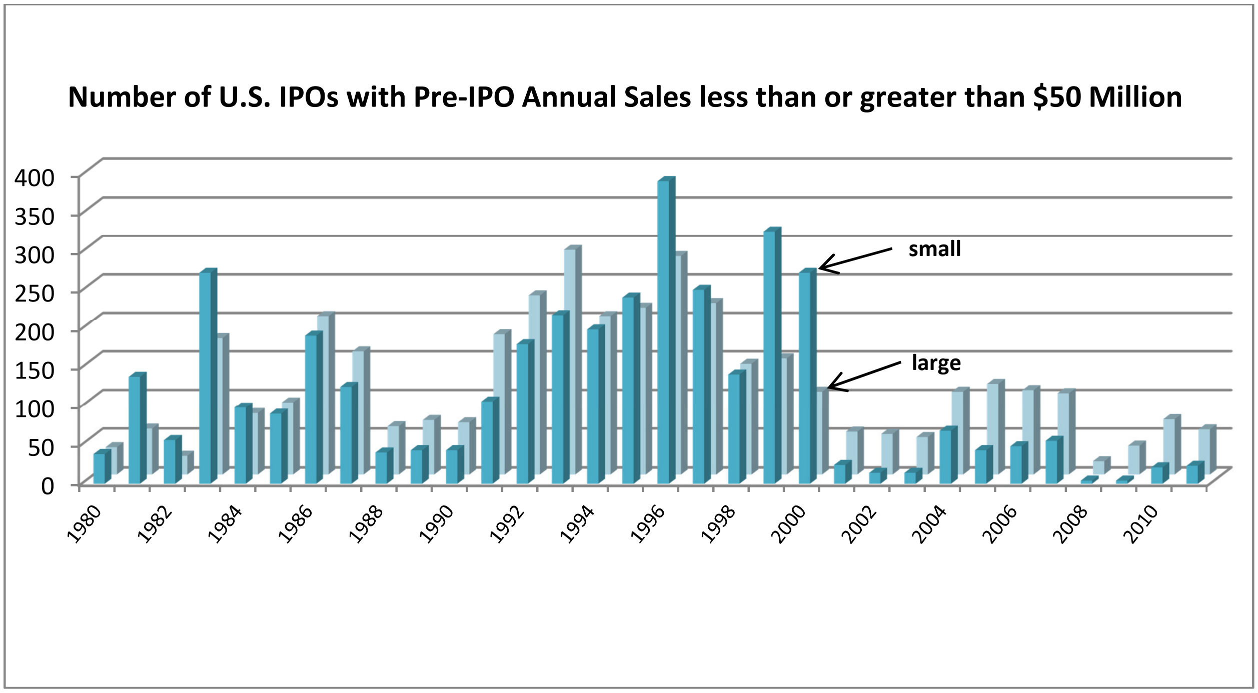

Figure 1: The number of U.S. IPOs by year, 1980-2011, with pre-IPO last twelve months sales less than (small firms) or greater than (large firms) $50 million (2009 purchasing power). Source: Gao, Ritter, and Zhu "Where have All the IPOs Gone?"

Although there is no disagreement about the existence of this prolonged drought in small company IPOs, there is disagreement about a) the causes of the decline in IPOs, b) the implications for the economy, and c) what should be done, if anything, to rejuvenate the IPO market and spur capital formation. My opinions about the causes of the decline are at odds with the conventional wisdom. My opinions about the implications for the economy are not too different from those of some, such as Prof. John Coates of Harvard Law School, who testified before this committee on December 14, 2011. These opinions are different, however, from those of the IPO Task Force, whose chair, Kate Mitchell, also testified on December 14, and those of the *Wall Street Journal*'s editorial writers. My opinions about what should be done are similar to those of several witnesses, but in disagreement with those of several others who have a much different opinion about the causes and implications than I do.

The Causes of the Decline in IPO Volume

The conventional wisdom is that a combination of factors, including a drop in public market valuations of tech companies, heavy-handed regulation such as Sarbanes-Oxley (SOX), and a drop in analyst coverage of small companies, have discouraged companies, especially small companies, from going public in the U.S. in the past decade. I agree with the conventional wisdom that these factors have discouraged small companies from going public, but I believe that only a small part of the drop in small company IPO volume can be explained by these factors. Instead, I think that the more fundamental problem is the declining profitability of small firms. In many industries, over time it has become more important for a firm to be big if it is to be profitable. Emerging growth companies (EGCs) are responding to this change in the merits of being a small, stand-alone firm by merging in order to grow big fast, rather than remaining as an independent firm and depending on organic (internal) growth.

Numerous facts support the idea that small companies are not going public because being small is not best, whether private or public. These facts are documented in "Where Have All the IPOs Gone?", coauthored with Xiaohui Gao and Zhongyan Zhu.[1] My co-authors and I document that U.S. public market investors have earned low returns in the three years after the IPO on the IPOs of small companies, defined as firms with less than $50 million in pre-IPO annual sales (2009 purchasing power), in every decade for at least thirty years. Furthermore, we show that for both recent IPOs and for public companies that have been traded for at least three years, the fraction of small companies with positive earnings has been on a long-term downtrend, starting far before the tech stock bubble burst in 2000. Other studies have documented that a larger and

[1] See "Where Have All the IPOs Gone?" Xiaohui Gao, Jay R. Ritter, and Zhongyan Zhu, March 2012, unpublished University of Florida working paper. Many additional tables can be found on the "IPO Data" page of my website (just Google "Jay Ritter").

larger fraction of aggregate corporate earnings are being earned by the largest firms, and that the fraction of public firms that earn positive profits in a year has been on a long-term decline.[2]

In the last decade, a larger fraction of venture capital-backed firms have sold out in trade sales rather than go public, as documented by Kate Mitchell in her December 14, 2011 testimony to this Committee. The IPO Task Force interprets this evidence as suggesting that the IPO market is broken. My coauthors and I show that, of the small companies that do go public, there has been an increase over time in the fraction that is subsequently acquired, and as well as the fraction that subsequently make acquisitions. This "eat or be eaten" evidence is consistent with the notion that getting big fast has become more important over time, and does not imply that the IPO market is broken.

My co-authors and I also show that in the last decade there has been no deterioration in analyst coverage for companies that do go public, inconsistent with the assertion that a lack of analyst coverage is deterring IPOs.

My co-authors and I address whether the low profitability of small publicly traded firms in the last decade can be attributed to the costs of compliance with SOX's Section 404. To ascertain whether this is important or not, we add back to earnings an estimate, provided by the U.S. SEC, of the SOX costs incurred by small firms. We report that the downtrend in profitability would be present even if these costs did not exist. Furthermore, as Prof. John Coates mentioned in his December 14th testimony, there has been no resurgence of small company IPOs after the SEC altered the regulations to lessen these costs.

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[2] See DeAngelo, Harry, Linda DeAngelo, and Douglas Skinner, 2004, "Are Dividends Disappearing? Dividend Concentration and the Consolidation of Earnings," *Journal of Financial Economics* 72, 425-456; and Fama, Eugene F., and Kenneth French R., 2004, "New Lists: Fundamentals and Survival Rates," *Journal of Financial Economics* 73, 229-269.

If the U.S. IPO market is broken for small companies, but being a small independent firm is still attractive, we might expect to see many small U.S. firms going public abroad. In fact, as documented by several studies, only a few U.S. firms per year have gone public abroad in recent years.[3] In "Europe's Second Markets for Small Companies," my co-authors and I document that European public market investors have earned low returns on European IPOs from 1995-2009 that listed on Europe's markets that cater to emerging growth companies.[4] Furthermore, we document that 95% of the listings on London's Alternative Investment Market (AIM) have been "placings," restricted to qualified institutional buyers (QIBs). Most of these IPOs have been for very small amounts, and no liquid market ever developed. The reality is that very few of the AIM IPOs would have qualified for Nasdaq listing.

In addition, if being small but public was unattractive relative to being small but private, we might see many U.S. publicly traded small companies going private. Instead, the vast majority of small companies that have voluntarily delisted have done so by selling out to a larger company, rather than by staying independent and going private.[5]

To summarize, there is a large body of facts supporting the view that the drop in small company IPO activity is due to the lack of profitability of small stand-alone businesses relative to their value as part of a larger organization. In my opinion, this is the major reason why venture capital-backed firms are selling out (merging) rather than going public. This is a large firm vs small firm choice, not a private firm vs. public firm choice. Although the IPO market may need

[3] Doidge, Craig, G. Andrew Karolyi, and René M. Stulz, 2009, "Has New York Become Less Competitive than London in Global Markets? Evaluating Foreign Listing Choices over Time," *Journal of Financial Economics* 91, 253-277.
[4] See "Europe's Second Markets for Small Companies," by Silvio Vismara, Stefano Paleari, and Jay R. Ritter, *European Financial Management*, forthcoming.
[5] See Table 8 of Gao, Ritter, and Zhu (2012).

reforms, private firms are not avoiding IPOs because the IPO market is broken, but because being part of a larger organization creates more value.

Implications for the Economy of the Decline in IPO Volume

In "Post-IPO Employment and Revenue Growth for U.S. IPOs, June 1996-December 2010," my co-authors and I document the employment and revenue growth for U.S. companies that went public from June 1996-December 2010.[6] For the 2,766 domestic operating company IPOs from this period, we find that the average company added 822 employees since their IPO. In the ten years after going public, the average company increased employment by 60%, amounting to a 4.8% compound annual growth rate (CAGR).[7]

One can use these numbers to calculate the number of jobs that would have been created if the average annual volume of domestic operating company IPOs from 1980-2000 had continued during 2001-2011, rather than collapsing. In 1980-2000, an average of 298 domestic operating companies per year went public, whereas an average of only 90 domestic operating companies per year have gone public since then, a difference of 208 IPOs per year. Over the eleven year period 2001-2011, this amounts to a shortfall of 2,288 IPOs, with 822 jobs per IPO lost. Multiplying these two numbers together results in a figure of 1.88 million jobs that were not "created" due to the IPO shortfall. This calculation assumes that these employees would have been sitting at home watching TV if they weren't hired by the recent IPO firm, and that the roughly $100 million raised per IPO would not have been invested in anything else. But, in a mechanical sense, 1.88 million jobs have been "lost."

[6] Martin Kenney, Donald Patton, and Jay R. Ritter, work in progress for the Kauffman Foundation on "Post-IPO Employment and Revenue Growth for U.S. IPOs, June 1996-December 2010."
[7] The 60% cumulative average growth in employment and 4.8% CAGR numbers are based on the 1,857 IPOs from June 1996-December 2000.

This 1.88 million figure is dramatically lower than the 10 million jobs figure that Delaware Governor Jack Markell used in his March 1, 2011 *WSJ* opinion piece "Restarting the U.S. Capital Machine," or the 22.7 million figure used in the IPO Task Force report presented to the U.S. Treasury and this Committee in late 2011 by task force chairwomen Kate Mitchell. The 22.7 million number comes from a 2009 Grant Thornton white paper, "A Wake-up Call for America," written by David Weild and Edward Kim. Weild and Kim make four different assumptions than my coauthors and I do in order to generate their 22.7 million jobs lost figure.

First, Weild and Kim make the reasonable assumption that IPO volume should be proportional to real GDP, and since the US economy has grown over the last thirty years, one would expect IPO activity to rise rather than be flat. Thus, our number, which assumes that IPO activity would be constant over time, is biased downwards.

Second, on page 26 Weild and Kim make the assumption that the normal level of IPO activity is that of 1996, the peak of the IPO market, and that the volume should grow from this level. This assumption, that the 1996 number of 803 IPOs is normal, biases their number upwards. Third, they assume that each IPO that didn't occur would have had 1,372 employees before going public, and post-IPO employment grows at a CAGR of 17.8%, a number that implies employment growing by 415% in the ten years after an IPO. The 17.8% per year number is justified based on a "select" group of prior IPOs. In other words, they assume that thousands of companies that didn't go public would have grown as fast as companies such as Google if they had! This assumption, which I would tend to categorize as completely ridiculous, has a huge impact on their calculations. Fourth, they assume that there was an IPO shortfall starting in 1997, rather than 2001, and that more than 1,500 additional firms would have gone public in 1997-2000 and then grown their employment by 17.8% per year for more than a decade. This 1997-

2000 shortfall assumption, combined with the 17.8% CAGR assumption, adds at least 9 million lost jobs to their 22.7 million total.

What Should Be Done

If the reason that many small companies are not going public is because they will be more profitable as part of a larger organization, then policies designed to encourage companies to remain small and independent have the potential to harm the economy, rather than boost it. Not all EGCs should stay private or merge, however, and to the degree that excessive burdens associated with going public, and being public, result in less capital being raised and wisely invested, standards of living are lowered. I do not think that the bills being considered will result in a flood of companies going public. I do not think that these bills will result in noticeably higher economic growth and job creation.

In thinking about the bills, one should keep in mind that the law of unintended consequences will never be repealed. It is possible that, by making it easier to raise money privately, creating some liquidity without being public, restricting the information that stockholders have access to, restricting the ability of public market shareholders to constrain managers after investors contribute capital, and driving out independent research, the net effects of these bills might be to reduce capital formation and/or the number of small EGC IPOs.

I think that Prof. John Coates zeroed in on the tradeoffs in his December 14, 2011 testimony. He stated "While the various proposals being considered have been characterized as promoting jobs and economic growth by reducing regulatory burdens and costs, it is better to understand them as changing, in similar ways, the balance that existing securities laws and regulations have struck between the transaction costs of raising capital, on the one hand, and the combined costs of fraud risk…" As he notes, fewer investor protections can potentially result in more fraud, with rational investors responding by demanding higher promised returns from all companies, resulting in good companies receiving a lower price for the securities that they sell. Good investor protection laws, and their timely and effective enforcement, can lower the cost of capital for good companies, but investor protection does impose compliance costs on all companies.

I will now comment on some of the specific bills under consideration by the Senate:

S. 1791 "Democratizing Access to Capital Act of 2011" and S. 1970 "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011"

These bills deal with Regulation D and its requirements on solicitations, and crowdfunding. In general, they reduce constraints on the ability of parties seeking capital to reach out to unsophisticated investors, potentially increasing the amount of fraud. Fraudsters are happy to relieve unsophisticated investors of their cash.

An increase in fraud if these bills are passed is not, however, an automatic result. When eBay and Craigslist were created, a concern was raised about whether fraud by sellers, and bounced checks from buyers, would be so prevalent that an electronic exchange that matched buyers and sellers of non-financial goods and services would fail. In practice, both organizations have been successful at matching buyers and sellers, even if there are some unsatisfactory outcomes.

In financial markets, as with eBay and Craigslist, it is possible that organizations will evolve that provide sufficient voluntary policing and certification to minimize the amount of fraud and create value by bringing buyers and sellers (investors and entrepreneurs) together.

I am not certain what problem crowdfunding is solving. Many startups are able to get funding from angel investors, and, once a certain threshold of size has been reached, venture capital (VC) firms have billions to invest. If VC firms were demanding excessively onerous terms, one might expect to see extremely high returns for the limited partners (LPs) of VC funds. Over the last decade, however, the bigger problem has been low returns. The market is not failing when firms with poor investment prospects are unable to get funding. The market is working when firms with good prospects are able to get funded at reasonable cost and grow, and firms with poor prospects are deprived of capital that would be wasted.

S. 1970 appears to offer some protections to investors that are not present in S. 1791. I am modestly supportive of S. 1970, but not enthusiastic about S. 1791.

S. 1824 "The Private Company Flexibility and Growth Act"

This bill increases the 12(g)(1) of the 1934 Act threshold at which public reporting of financial statements is required from 500 to 2,000 shareholders of record, and Section 3 removes current and past employees from the count. The number of beneficial shareholders, of course, may be far in excess of the number of shareholders of record since individuals normally hold shares in street name.

On December 1, 2011, Prof. John Coffee of Columbia Law School testified that the shareholders of record requirement should be supplemented with a public float requirement: if either the 2,000 shareholders of record threshold is passed, or if the public float is above $500 million, public reporting should be required.

My suggestion would be to keep the 500 shareholders of record threshold, but exclude current and former employees from the count, and to add a public float requirement.

Alternatively, the "shareholders of record" requirement should be changed to reflect the fact that for publicly traded firms, individuals keep their shares in street name.

S. 1933 "Reopening American Capital Markets to Emerging Growth Companies Act of 2011"

This bill establishes a new category of issuers, called emerging growth companies (EGCs) that have less than $1 billion in annual revenue at the time of SEC registration, and exempts them from certain disclosure requirements, such as executive compensation. The exemptions would end either five years after the IPO or when the annual revenue exceeds $1 billion.

From 1980-2011, 7,612 operating companies went public in the U.S., excluding banks and S&Ls and IPOs involving units, an offer price below $5.00, or partnerships. 94% of these companies had annual sales of below $1 billion when they went public, including Carnival Cruise Lines and AMF Bowling.

Section 3 deals with disclosure obligations. I cannot think of any reason for why public market investors should not need to know how much executives are paying themselves, nor have a say on this cost through shareholder voting.

Section 6 deals with coverage from sell-side research analysts. As I interpret it, this legislation would abolish quiet period restrictions on the ability of sell-side analysts that work for an underwriter to provide research to institutional investors for EGCs, which historically have comprised 94% of all IPOs. Because the sell-side analysts are potentially privy to inside information, they will be at an informational advantage relative to other analysts. This proposed legislation is completely at odds with the logic of Reg FD, which seeks to create a level playing field. The proposal may have the effect of crowding out unbiased independent research.

As I mentioned earlier in this testimony, my research shows that there has been no lack of analyst coverage of companies conducting IPOs in the last decade.[8] If the purpose of Section 6 is to create incentives for analyst coverage because none exists, this legislation is based on a faulty premise.

[8] Table 6 of Gao, Ritter, and Zhu (2012) shows that essentially all IPOs with a midpoint of the file price range of above $8 receive coverage. This $8 cutoff is a good proxy for IPOs that are large enough to attract institutional investors.