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Capital Access: IPO and "IPO On-Ramp"

Raising capital through public offerings was traditionally viewed as a significant step for companies to achieve growth and create jobs. Its importance, however, has deteriorated over the last two decades, as measured by the decline in the number of initial public offerings (IPOs). In response to this market trend, Congress established a number of new capital access options in 2012 through the Jumpstart Our Business Startups Act (JOBS Act; P.L. 112-106), including the creation of a new issuer type—emerging growth company (EGC)—to scale down compliance requirements and facilitate IPOs. Because of the rapid adoption of the EGC status by companies going public, some in Congress have proposed widening its access by expanding the length of time an EGC could maintain its status or by extending certain EGC benefits to other IPOs. This has been a source of policy debate.

Public Offerings and the IPO Process

A public offering refers to when a company raises funds from the public at large rather than a narrower group of sophisticated investors. Public offerings consist of IPOs, the first time a company offers its shares of stock to the general public in exchange for cash, and subsequent public offerings. A company can access funding from other sources of capital, such as bank loans or private equity firms, but it may choose to conduct public offerings—which require rigorous Securities and Exchange Commission (SEC) disclosure—for multiple reasons, including fueling the company's future growth; allowing the founders to cash out their investments; providing stock incentives to employees; and enhancing corporate brand awareness. The IPO process, which is a focal point of the policy debate surrounding public offerings, is commonly regarded as the turning point for companies "going public." The IPO process generally consists of three phases.

Pre-filing Period. As part of an IPO, a company must file a registration statement and other documents that contain information about the company and the funds it is attempting to raise. During the pre-filing period, the public filings are prepared and the planning begins with a thorough review of the company's operations, procedures, financials, and management, as well as its competitive positioning and business strategy. The disclosure documents serve the dual purpose of satisfying SEC registration requirements and communicating with investors.

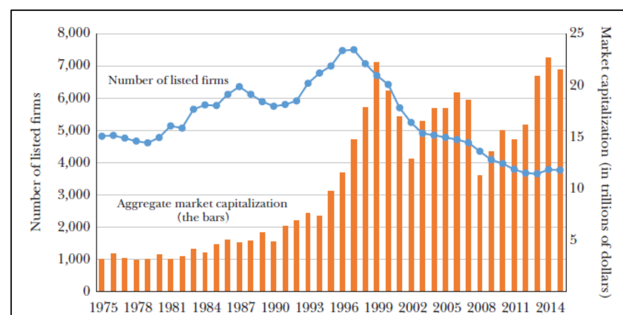
Waiting Period. Once the key disclosures are filed, the company waits for the SEC to review and provide approval. During the waiting period, the company concurrently addresses SEC comments and prepares roadshow presentations as well as other legal documents needed to consummate the sale. Roadshows are presentations made by an issuer's senior management to market the upcoming securities offering to prospective investors. Roadshows can commence only after the filing of registration statements.

Post-effective Period. The actual sales to investors take place after the SEC declares that the IPO registration is effective. The post-effective period extends from the effective date of the registration statements to the completion of distribution of the securities. With the completion of the IPO, the securities generally continue to trade on a stock exchange.

Market Trends

Going public was traditionally viewed as a significant funding source for growing companies. More recently, however, the number of U.S.-listed domestic public companies has declined by half over the last two decades (**Figure 1**) while listings are estimated to have risen by half in other developed countries over the same time period. Overall, the number of public companies declined due to mergers, acquisitions, and delistings (removal of securities from exchanges). In addition, part of the decrease in the number of public companies is due to the decrease in IPOs. According to data provider Dealogic, U.S. IPOs raised $49.3 billion through 189 offerings in 2017, more than double 2016's level of $24.2 billion raised through 111 offerings. Though the total number of IPOs increased in 2017, it has remained far below the IPO average of more than 500 per year in the 1990s. However, whether the 1990s, which experienced the dot-com bubble, is an appropriate benchmark is a point of contention as well.

Figure 1. Number of U.S.-Listed Public Companies and Aggregate Market Capitalization



Sources: Center for Research in Security Prices; and Kathleen M. Kahle and René M. Stulz, "Is the U.S. Public Corporation in Trouble?" *Journal of Economic Perspectives*, vol. 31, no. 3, pp. 67-88.

"IPO On-Ramp"–Emerging Growth Companies

In response to declining IPOs over the last two decades and in an effort to reduce barriers for smaller companies accessing public offerings, Title I of the JOBS Act established streamlined compliance options for companies that meet the definition of a new type of issuer, called an

emerging growth company. The streamlined process available to an EGC is called "IPO On-Ramp" because it is a scaled-down version of a traditional IPO. To qualify as an EGC, a company must have total annual gross revenue of less than $1 billion during its most recently completed fiscal year. EGCs maintain their status for five years after their IPO or until their gross revenue exceeds $1 billion, among other conditions. Relative to a conventional IPO, EGCs have the following features:

- Scaled-back disclosure requirements in which they (1) may use two years of financial statements certified by independent auditors, instead of three years for a traditional IPO; and (2) are not required to provide compensation committee reports, among other things.
- An exemption from auditor attestations of internal control over financial reporting that are required by Section 404(b) of the Sarbanes-Oxley Act (P.L. 107-204).
- "Test-the-waters" communications, meaning the EGCs may meet with qualified institutional buyers and institutional accredited investors to gauge their interests in a potential offering during the registration process, an activity prohibited during a normal IPO.
- A confidential SEC review process that allows companies to submit draft registration statements to the SEC for a confidential preliminary review for agency input.

Although the reduced compliance requirements more obviously generate cost savings for all EGC status holders, the confidential review and test-the-waters features are especially valuable for companies in industries where a company's valuation is uncertain and the timing of the IPO depends on regulatory or other approval (e.g., biotechnology). The ability to have confidential SEC review and conduct test-the-waters communications with prospective investors provides additional flexibility for companies considering IPOs.

A biotechnology EGC testified during a recent congressional hearing that 212 emerging biotech companies went public under EGC status as of March 2017, relative to 55 biotech IPOs in the five years leading up to the JOBS Act. This may indicate that taking advantage of EGC status potentially enhances biotech capital access.

The EGC provision is a widely adopted part of the JOBS Act. Around 87% of the firms that filed for an IPO after April 2012 were EGCs at the time of filing, leaving 13% of IPOs still going through the conventional process. Most EGCs availed themselves of the confidential review and the reduced submission requirements for audited financial reports.

The SEC expanded the option of confidential review to all companies effective on July 10, 2017, to allow non-EGC companies to benefit from the process. Most companies now use the SEC confidential review to incorporate feedback prior to public disclosure and announcement.

Legislative Proposals

Following the EGC regime's rapid ramp-up, there are new legislative proposals to expand IPO On-Ramp by either lengthening the amount of time EGCs could maintain their status or expanding certain EGC benefits to all IPO firms.

Section 441 of H.R. 10 and H.R. 1645 would allow companies to extend the length of time that a company could be an EGC. A company would maintain its EGC status through the earliest occurring event of (1) 10 years after the EGC went public; (2) the end of the fiscal year in which the EGC's average gross revenues exceed $50 million; or (3) when the EGC qualifies with the SEC as a large accelerated filer ($700 million public float, which is the number of shares that are able to trade freely among investors that are not controlled by corporate officers or promoters).

Section 499 of H.R. 10 and H.R. 3903 would allow all issuers making an IPO (1) to communicate with potential investors before the offering (test-the-waters) and (2) to file confidential draft registration statements with the SEC. These benefits were previously available only to companies with EGC status. As mentioned earlier, the SEC recently expanded the EGC confidential review benefit to all companies effective July 10, 2017. The SEC is also reportedly studying a move to expand the test-the-waters benefit.

Key Policy Issues

Proposals to facilitate IPOs by providing regulatory relief often involve two potentially conflicting core SEC statutory missions: (1) fostering investor protection largely through mandatory disclosure; and (2) facilitating capital formation. Proposals that reduce the registration and disclosures that a company must make can decrease the company's compliance costs and increase the speed and efficiency of capital formation, but the reduced disclosures may expose a company's investors to additional risks if they are not receiving information that is important to informed investment decisionmaking.

Proponents of expanding the JOBS Act's EGC-based regulatory relief argue that the measures have benefited capital formation without sacrificing investor protection. They also assert that many private companies are reluctant to go public due to regulatory impediments and thus could benefit from further regulatory relief.

In addition to investor protection concerns about disclosure, critics point to the lighter regulatory standards under EGC that currently dominate the IPO process. They believe the EGC regime appears to have enabled many relatively financially weak companies to conduct IPOs. The EGC firms are also said to have experienced underpricing relative to comparable firms. Underpricing refers to IPOs that are issued at below market value, leaving less money to fund company growth.

For more on capital access, see CRS In Focus IF10848, *Capital Access: SEC Regulation A+ ("Mini-IPO")*, by Eva Su.

Eva Su, Analyst in Financial Economics

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