INTERNATIONAL AND U.S. IPO PLANNING

A Business Strategy Guide

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Chapter 1

Pros and Cons of a U.S. IPO

The New York Stock Exchange (NYSE) and the Nasdaq Stock Market (Nasdaq) are the most prestigious stock markets in the world and are likely to remain so for the next five years. However, they are facing increasing competition from foreign stock exchanges.

A private company considering an initial public offering (IPO), regardless of where in the world the private company is located, should first consider the NYSE and the Nasdaq for an IPO because these stock markets are well regulated and highly liquid and have strong corporate governance standards. For private companies that will have, after an IPO, a market valuation of over $250 million, these prestigious U.S. exchanges are the first places to consider. However, this is not necessarily true for smaller private companies (whether U.S. or international) planning an IPO, as discussed later in this chapter.

We begin the discussion of the pros and cons of a U.S. IPO by considering two topics:

1. Underwriter spreads and underpricing
2. IPO offering expenses and post-IPO compliance expenses

We then review the increasing international competition with U.S. IPO markets, particularly for smaller IPOs, and the reasons why smaller companies may wish to consider an international IPO as an alternative. Finally, we suggest changes that can be made to the U.S. regulatory structure to make it more attractive for smaller IPOs.

UNDERWRITER SPREADS AND UNDERPRICING

Underwriter spreads,[1] or "discounts," in the traditional U.S. IPO market typically run approximately 7%. Strong IPOs may have underwriter discounts less than 7%; weak IPOs may have underwriter discounts higher than 7%. The term "underwriter discount" refers to the excess of the IPO public offering price for the stock that is sold by the underwriter to the public over the price paid to the company for that stock by the underwriter. For example, if the IPO public offering price is $20 per share, and the price that the underwriter pays to the company is $18.60, the $1.40 difference is the 7% underwriter discount.

In contrast, it has been reported that underwriter discounts in a number of foreign IPO offerings are as low as 2%. (See Exhibit 1.1 on international underwriter spreads; although somewhat dated, it is still relevant.) Although this is a major cost differential, particularly in a large offering, it can be justified in some cases by the higher valuation for the company obtained in the U.S. market and the better distribution of the shares sold in the IPO. Likewise, if the U.S. underwriter provides greater after-market support for the stock, this could also justify the greater underwriter discount.

One study in 2002 found that although foreign issuers pay more to get a U.S. lead bank to arrange a bookbuilding IPO, they also end up with lower underpricing. (Underpricing is the percentage difference between the price at which the IPO shares were sold to investors—the public offering price—and the price at which the shares subsequently trade in the market.) The higher U.S. underwriter discount is generally more than offset by savings in the underpricing, which is the amount of money left on the table by the IPO company.[2] A 2004 study found

Exhibit 1.1 Spread Levels in IPO Markets around the World Based upon 10,990 IPOs

	Mode Spread		Gross Spread (%)
Countries	Level (%)	Relative Frequency	Median
Australia	4.00	21.2%	4.0
Hong Kong	2.50	94.8%	2.5
India	2.50	86.0%	2.5
Indonesia	3.50	27.3%	3.5
Malaysia	2.00	88.8%	2.0
New Zealand	nm	nm	5.5
Philippines	3.00	65.4%	5.5
Singapore	2.50	55.7%	2.5
Thailand	3.00	42.9%	3.0
Total Asia Pacific	**2.50**	**66.7%**	**2.5**
Austria	3.00	18.5%	3.5
Belgium	2.50	66.7%	2.5
Denmark	4.00	25.0%	4.0
Finland	4.00	25.0%	3.8
France	3.00	34.0%	3.0
Germany	4.00	38.6%	4.0
Greece	3.00	40.0%	3.0
Ireland	nm	nm	3.3
Italy	4.00	18.2%	4.0
Netherlands	3.25	13.0%	3.7
Norway	4.00	28.6%	4.1
Portugal	3.25	16.7%	3.5
Spain	3.50	26.5%	3.5
Sweden	4.50	14.8%	4.3
Switzerland	4.00	33.3%	4.0
United Kingdom	6.00	8.9%	3.6
Total Europe	**4.00**	**15.6%**	**4.0**
Canada	6.00	18.3%	6.5
United States	7.00	43.0%	7.0
Total North America	**7.00**	**39.8%**	**7.0**

Source: Journal of Financial and Quantitative Analysis, Vol. 38, No. 3, pp. 475–501 (September 2003); Social Science Research Network, www.ssrn.com/.

that underpricing is reduced by 41.6% on average when U.S. banks and U.S. investors are involved. Even after the higher underwriter discount charged by U.S. underwriters is subtracted, one study estimated that 73% of issuers would have been worse off had they chosen foreign banks and foreign investors.[3] However, it is not clear that the U.S. IPO has any significant underpricing advantage when compared to an IPO on the Alternative Investment Market (AIM) of the London Stock Exchange, as discussed in Chapter 9.

An interesting study of U.S. IPOs found that the higher the selling concession made by the underwriter to the selling group of investment bankers, the higher the IPO offering price and consequently the lower the underpricing. This study suggests that IPO candidates should be looking for underwriters that provide generous selling concessions to the selling group.[4]

Underpricing varies from country to country and is markedly lower in some countries, such as Denmark, Luxembourg and certain South American countries,[5] and is markedly higher in China. The average underpricing of Chinese IPOs is 247%, the highest of any major world market.[6]

IPO OFFERING EXPENSES AND POST-IPO COMPLIANCE EXPENSES

IPOs in the United States typically have significantly higher offering expenses than international IPOs. Legal and accounting fees, printing, and other related expenses are substantially higher in the United States than in many other countries. Chapter 9 contains a 2006 comparison of IPO offering expenses on AIM versus a Nasdaq IPO that indicates that the Nasdaq IPO expenses are more than $1.8 million higher than the AIM IPO expenses.[7] However, the legal and accounting expenses quoted in 2007 for AIM offerings are, as a result of the devaluation of the U.S. dollar, in the neighborhood of $400,000 to $1 million each and therefore do not significantly differ from U.S. legal and accounting expenses.[8]

The Tel Aviv Stock Exchange claims that the legal, accounting, printing, and public relations costs for its IPOs are only $155,000 and annual maintenance costs (excluding directors' and officers' [D & O] insurance) are only $260,000.[9] IPO expenses on the Bombay Stock Exchange in India are estimated to be 65% to 75% lower than U.S. costs.[10]

Except for small public offerings, offering expenses are only a very small percentage of the net proceeds of most IPOs. The tendency for U.S. IPOs to be less "underpriced" than international IPOs may make up for all or some of the difference in these offering expenses. However, the advocates for AIM IPOs dispute the assertion that their IPOs have any greater underpricing than U.S. IPOs (see Chapter 9).

The post-IPO regulatory compliance expenses are also significantly higher in the United States than internationally. These post-IPO compliance expenses are usually not material for large-capitalization (cap) IPOs. For companies having a post-IPO market value of less than $250 million, these expenses can be material. These expenses can become very material for companies having a post-IPO market value of less than $100 million. For example, it has been estimated that, annually, the cost of being a $200 million market cap public company on Nasdaq is more than $1.4 million higher than the annual cost of an AIM public company.[11]

INCREASING COMPETITION TO U.S. IPO MARKETS

The competitiveness of the U.S. public market has been seriously challenged in recent years.[12] For example, during the dot-com boom the European IPO market attracted more IPOs in the years 1998 to 2000 than the U.S. stock markets.[13]

According to a report by the Committee on Capital Markets Regulation, the competitiveness of the U.S. public markets has deteriorated significantly in recent years.[14] The report states:

> Whereas 43 foreign companies cross-listed in the U.S. without raising capital in 2000, only 4 did so in 2007 through September. In 2006, six

> foreign companies cross-listed in the U.S. The obvious inference is that foreign companies see diminishing value in bonding to U.S. standards.

In addition, through October 2007, a record of 56 foreign companies delisted from the NYSE.

According to the report, in 1996, 8 of 20 of the largest global IPOs were in the United States, whereas none of the 20 largest global IPOs was conducted in the United States in 2007. IPOs of U.S. companies abroad increased from 0.1% during the 1996 through 2005 period to 4.3% in 2007.

One can argue that the growth of economies outside of the United States is a significant contributor to the growing international IPO competition. However, that is not the only reason. The Sarbanes-Oxley Act of 2002 (SOX) has given the U.S. markets a bad international reputation.

One commentator has stated:

> The now-infamous Sarbanes-Oxley Act in the United States . . . created massive barriers to fraud but, in its wake, a negative environment for the US exchanges. The cost for issuers of compliance with Sarbanes-Oxley reached such a high level that those with a choice started to abandon US equity markets.[15]

The poor reputation of SOX internationally is mostly undeserved, with one major exception and several minor ones. The major exception is the provision of Section 404 that required an auditor attestation report on internal controls. That provision initially caused major cost expenditures by public companies, primarily as a result of poor regulatory implementation (which has now, it is hoped, been corrected), but unfortunately seriously damaged the international reputation of SOX. Some U.S. audit committee chairpersons currently believe that Section 404 of SOX actually has been of significant benefit to their companies by forcing the improvement of internal controls.

According to the report of the Committee on Capital Markets Regulation, as illustrated in Exhibit 1.2,[16] through the third quarter of 2007,

Exhibit 1.2 Share of Global IPOs (Narrowly Defined) Captured by U.S. Exchange

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007*
Total Number of Global IPOs	105	118	85	112	136	45	47	54	122	192	237	209
Number of Global IPOs Listed on a U.S. Exchange	61	57	41	52	74	10	3	5	28	28	34	32
% of Total Number	55.8%	48.3%	48.2%	46.4%	54.4%	22.2%	6.4%	9.3%	23.0%	14.6%	14.3%	15.3%
($ billions)												
Total Value of Global IPOs	32.3	46.8	25.2	45.4	43.1	15.1	3.7	12.4	21.5	40.5	97.8	
Value of Global IPOs Listed on a U.S. Exchange	24.9	34.3	15.6	34.4	35.3	7.6	2.5	4.9	9.2	4.5	10.8	8.5
% of Total Value	77.3%	73.3%	62.0%	75.8%	81.8%	50.6%	67.1%	39.5%	42.7%	11.2%	11.0%	13.8%

*2007 data through September.

Source: Dealogic.

NOTE: According to Renaissance Capital (www.ipohome.com), Visa's record $17.9 billion U.S. IPO in March 2008 helped the U.S. increase its total IPO proceeds to 33% during the first six months of 2008; however, excluding Visa, the remaining 16 U.S. IPOs captured just 7% of global IPO proceeds during this period.

15.3% of global IPOs were listed on a U.S. exchange, compared with an average of 51.1% in the period from 1996 to 2000. Similarly, U.S. exchanges have captured just 13.8% of the total value of global IPOs to date in 2007, compared with an average of 74.0% in the period from 1996 to 2000.

The report of the Committee on Capital Markets Regulation goes on to discuss the increasing trend of U.S. companies listing their IPOs only on a foreign exchange, as illustrated in Exhibit 1.3.[17]

The only positive trend reflected in the report of the Committee on Capital Markets Regulation is the increase in the value of "Rule 144A IPOs," which is defined as IPOs by foreign companies *privately* offered in the United States pursuant to Securities and Exchange Commission(SEC) Rule 144A. As noted in the report:

> . . . the Rule 144A market is not subject to SEC regulation under the '34 Act (including the Sarbanes-Oxley Act) and the standard of liability is lower than in the public market . Moreover, because access to this market is restricted to large institutions, the risk of securities class actions is generally lower.

In effect, the foreign companies are willing to raise capital in the United States only if they are exempted from SEC reporting requirements and SOX.

The report of the Committee on Capital Markets Regulation is further supported by statistics from the World Federation of Exchanges.[18] Exhibit 1.4 is an excerpt from a chart in the annual report of the World Federation of Exchanges on the number of newly listed companies by each exchange. The chart reflects the growing importance of the London Stock Exchange, Shanghai Stock Exchange, and the Hong Kong Exchanges. Because these figures include IPOs and listings of investment funds, they significantly overstate the actual dollar amount of IPOs of operating companies, particularly for the NYSE.

Some have argued that the decline in the IPO market share of U.S. securities exchanges is due to the greater number of capital choices available to U.S. private companies. It is true that a foreign private

Exhibit 1.3 Share of U.S. IPOs Listed Only on Foreign Exchanges

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007*
Total Number of U.S.-Domiciled IPOs	497	398	300	459	341	119	157	129	263	232	189	163
Number of U.S.-Domiciled IPOs Listed Abroad Only	1	0	2	0	0	0	2	1	5	8	12	15
% of Total Number	0.2%	0.0%	0.7%	0.0%	0.0%	0.0%	1.3%	0.8%	1.9%	3.4%	6.3%	9.2%
($ billions)												
Total Value of U.S.-Domiciled IPOs	28.0	32.5	37.5	65.7	62.6	45.2	41.7	44.7	65.9	55.1	44.2	57.4
Value of U.S.-Domiciled IPOs Listed Abroad Only	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.5	0.5	2.5
% of Total Value	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.9%	1.1%	4.3%

*2007 data through September.

Source: Dealogic.

company wishing to raise capital in its home country may be forced into an IPO solely because of the lack of local private equity resources. However, an equally plausible explanation is that there is no easily accessible IPO market in the United States for smaller companies and that the costs and burdens of a U.S. IPO substantially exceed those of any other country. Thus, small U.S. private companies wishing to obtain growth capital are forced to seek private equity financing.

Private equity is not necessarily the best alternative to grow a private company. By their nature, private equity funds will tend to place lower valuations on their investee companies than the IPO marketplace, may have shorter exit horizons and different objectives from the founders of these investee companies, and may take control of the private company away from the founders, leveraging the company with significant debt. The presence of a strong IPO market permits founders and other entrepreneurs to retain control of the public company after the IPO, and to grow the company with less dilutive public equity. More important, an active IPO market serves a social purpose by permitting the public, including persons who could not qualify to invest in private equity funds, to invest in new growth companies.

Exhibit 1.4 Exchange Listings

			Newly Listed Companies 2007	
Exchange	(US$ millions) Initial Public Offering	Total	Domestic Companies	Foreign Companies
Americas				
American SE	N/A	92	71	21
Bermuda SE	N/A	6	0	6
Buenos Aires SE	234.1	5	5	0
Colombia SE	4,597.1	7	7	0
Lima SE	0.0	15	8	7
Mexican Exchange	888.0	63	4	59
Nasdaq	16,192.6	153	128	25
NYSE Group	60,385.8	126	84	42
Santiago SE	230.2	6	4	2

São Paulo SE	27,834.2	70	64	6
TSX Group	7,369.5	408	381	27
Asia Pacific				
Australian SE	16,725.5	292	276	16
Bombay SE	9,642.8	136	136	0
Bursa Malaysia	317.4	22	22	0
Columbo SE	0.0	0	0	0
Hong Kong Exchanges	37,485.9	84	82	2
Indonesia SE	1,976.3	22	22	0
Jasaq	688.6	49	49	0
Korea Exchange	3,170.0	98	96	2
National Stock Exchange India	7,874.1	201	201	0
New Zealand Exchange	316.7	9	7	2
Osaka SE	179.5	28	28	0
Philippine SE	412.1	11	11	0
Shanghai SE	57,770.0	25	25	0
Shenzhen SE	5,670.7	101	101	0
Singapore Exchange	5,159.8	76	20	56
Taiwan SE Corp.	566.1	30	30	0
Thailand SE	332.6	13	13	0
Tokyo SE Group	N/A	68	65	3
Europe—Africa—Middle East				
Amman SE	606.9	18	18	0
Athens Exchange	15.8	4	3	1
BME Spanish Exchanges	21,726.2	192	191	1
Börsa Italiana	5,930.8	33	33	0
Budapest SE	9.5	3	1	2
Cairo & Alexandria SEs	866.8	20	20	0
Cyprus SE	279.9	4	4	0
Deutsche Börse	N/A	65	62	3
Euronext	13,329.9	46	30	16
Irish SE	2,159.9	9	7	2
Istanbul SE	3,372.8	9	9	0
JSE	0.0	62	54	8
Ljubljana SE	1,233.0	4	4	0
London SE	50,026.2	411	270	141
Luxembourg SE	265.7	20	1	19
Malta SE	42.4	2	2	0
Mauritius SE	0.0	7	6	1

(*Continued*)

Exhibit 1.4 (*Continued*)

Exchange	(US$ millions) Initial Public Offering	Total	Newly Listed Companies 2007 Domestic Companies	Newly Listed Companies 2007 Foreign Companies
OMX Nordic Exchange	6,057.4	94	90	4
Oslo Bors	1,778.4	30	24	6
Swiss Exchange	1,265.7	N/A	N/A	N/A
Tehran SE	505.4	9	9	0
Tel Aviv SE	2,707.4	64	61	3
Warsaw SE	5,486.4	105	93	12
Wiener Börse	2,337.1	9	7	2

COMPETITION SOURCES

Competition to U.S. exchanges arises primarily from three sources:

1. The London Stock Exchange (AIM), Hong Kong Stock Exchanges, Shanghai Stock Exchange, and other major foreign exchanges.
2. The use of Rule 144A IPOs. These private sales of equity securities to large institutional investors by both foreign companies and U.S. companies are thereafter listed for trading on alternative nonpublic markets, such as the GS Tradable Unregistered Equity OTC Market (GS TRuE) sponsored by Goldman Sachs & Co.
3. The difficult regulatory, legal (including litigation), accounting, and activist shareholder environment in the United States, which adversely affects the IPOs of smaller companies in particular.

The increasing prominence of foreign stock exchanges was illustrated by the announcement in July 2008 that the common shares of NYSE Euronext Inc., which owns the NYSE, would also be listed on the Shanghai Stock Exchange at the same time its common shares are traded on a European and U.S. exchange.[19]

The remainder of this chapter focuses on the use of Rule 144A IPOs and the problems of small-cap IPOs in the United States.

RULE 144A IPOS

Prior to 2007, private sales under Rule 144A to large institutional investors (called ‘‘qualified institutional buyers’’) by both foreign and U.S. companies was not considered an alternative to a publicly traded IPO. However, the development of alternative trading systems by major investment banks has created an alternative private IPO market. For example, in May 2007, Oaktree Capital Management LLC, a leading private U.S. hedge fund advisory firm, sold a 15% equity stake in itself for $880 million.[20] The deal was unusual because it was not structured as an IPO but rather a private placement to generally institutional investors holding more than $100 million of securities under Rule 144A of the Securities Act of 1933 (1933 Act). The stock was then traded on GS TRuE. This structure enabled the company to market and sell securities through an IPO that was not subject to the registration provisions of either the 1933 Act or the Securities Exchange Act of 1934 (1934 Act) and therefore was not subject to the burdensome provisions of SOX and related SEC regulations.

In August 2007, Apollo Management LP, a well-known private equity fund advisor, sold a 12.5% stake for $828 million in a similarly structured Rule 144A transaction, and the stock was subsequently traded by the institutional investors on GS TRuE.[21] In July 2007, Apollo sold 10% each to Calpers and to the Abu Dhabi Investment Authority, for a total of $1.2 billion.

In 2007, the Rule 144A offerings by U.S. issuers raised an amount greater than the amount raised in U.S. public offerings.[22] One academic has characterized this as a ‘‘paradigm shift’’ in the securities markets and a trend toward deretailization.[23] In effect, investors in the retail market are being increasingly foreclosed from the ability to invest in new IPOs.

SMALL-CAP IPOS

The IPO market for larger companies in the United States, either through traditional IPOs on the NYSE or Nasdaq or through private sales under Rule 144A, contrasts sharply with the IPO market for smaller companies. Few, if any, smaller companies would be of interest to large institutional investors for a Rule 144A transaction in the United States. Traditional IPOs for smaller companies have become very difficult in the United States.

When the post-IPO market valuation of a company is below $250 million, the advantages of the U.S. stock markets begin to decrease and materially decrease when the post-IPO market valuation is below $100 million. Many large institutional investors will not consider investments in companies having a post-IPO market valuation of less than $250 million. It becomes much more difficult to obtain coverage of the stock by securities analysts. These problems are exacerbated when the post-IPO market capitalization is below $100 million. The risk of the smaller U.S. public company becoming a so-called orphan (i.e., not followed by any securities analysts) is very real.

A 2006 study stated:

> 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 . . . [in] an IPO with a market value [at the end of first day] of over fifty-three and a half million, can net [after five million dollars of underwriting discounts and other fees and expenses] only forty-five million dollars in cash or less, a seventeen percent or more charge. Moreover, 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.[24]

A 2000 GAO report stated:

> [A]ccording to investment bankers we interviewed, businesses doing IPOs of less than $50 million generally are having a difficult time attracting large investment banking firms (e.g., Merrill Lynch and Goldman Sachs) to underwrite their public offerings. The investment bankers said this is the case partly because of high, fixed costs, including high, after-market monitoring costs and the need to make large-size investments. Therefore, these IPOs are commonly distributed by third- and fourth-tier investment banks rather than prestigious first-tier investment banks. Investors are less inclined to invest in small offerings placed with lower-tier investment banks because such firms often do not have the same market recognition that the large firms command. Further, we were told that another problem for these small issues is finding a securities analyst to cover the stock. In addition, investment bankers said that economies of scale typically make IPOs under $50 million uneconomical for larger investment banking firms.[25]

Smaller U.S. private companies may wish to consider an IPO outside of the United States. Prior to electing an international IPO, however, smaller U.S. private companies should consider an IPO in the country, even if the IPO is effectuated with a lower-tier underwriter on the OTC Bulletin Board or on the so-called Pink Sheets or through a reverse merger into a public shell (Chapter 12) or with a so-called SPAC (special-purpose acquisition company), discussed in Chapter 13. However, if none of these alternatives is feasible, an international IPO offering should be considered.

PROBLEMS OF SMALL-COMPANY IPOS

Smaller U.S. private companies face these problems in planning for an IPO in the major U.S. securities markets (each of which will be explored in more depth in this chapter):

- Significant accounting cost of complying with complex U.S. generally accepted accounting principles (GAAP) and SEC materiality rules, compared to more flexible international accounting standards

- Requirements to have a significant number of expensive independent directors on the board of directors, typically at least three on the audit committee and a majority of the board if the post-IPO company is not considered a ‘‘controlled company,’’ in contrast to much less stringent requirements on international exchanges
- Expansive and burdensome SEC post-IPO reporting requirements, compared to the less detailed reporting requirements for international IPOs, which results in greater legal, accounting, and internal compliance costs for U.S. IPOs

These expensive requirements generally do not exist with respect to international IPOs. Many of these U.S. requirements are the result of the corporate corruption scandals (e.g., Enron and WorldCom) in the early twenty-first century that led to waves of new corporate governance requirements. Although scandals involving major public companies outside the United States occasionally occur (e.g., Parmalat), the international standards have not been changed to the same degree as the U.S. IPO standards.

The changes in the U.S. rules come from many sources, including the Financial Accounting Standards Board, the Public Company Accounting Oversight Board, the U.S. Securities and Exchange Commission, the NYSE, Nasdaq, and the pressures from activist shareholders, including hedge funds.

SEC’S ROLE

The SEC has, in particular, adopted burdensome disclosure regulations affecting small U.S. IPOs by failing to adequately distinguish between large and small public companies. The U.S. Regulatory Flexibility Act[26] requires the SEC to analyze the effect of its proposed regulations on ‘‘small entities.’’ The SEC dutifully does so, generally with only minor and typically meaningless concessions to the problems of small businesses. Unfortunately, this statute does not require the analysis of the *cumulative* effect of all SEC rules on small businesses, only the particular regulation being adopted.

The cumulative effect of all of the SEC rules is to inflict on U.S. small businesses the equivalent of death by a thousand cuts. The result has been that the legal and accounting costs of complying with SEC rules are so large for many small businesses that they either (a) are forced to seek private equity to become large businesses before attempting an IPO, or (b) must abandon any exit through an IPO and consider only a sale exit. In the SEC's defense, some of its more burdensome rules have been the result of SOX and other pressures from the U.S. Congress.

The SEC should follow the example of the Tel-Aviv Stock Exchange, which has special rules for R&D companies that need to raise capital in their early stages. An R&D company is a company that has invested at least NIS 3 million (approximately $833,000) in research and development over the last three years, including investments using funds received from the Office of the Chief Scientist at the Israel Ministry of Industry and Trade. These R&D companies are permitted to offer their shares to the public under very lenient terms.[27]

These complex and burdensome SEC regulations have increased the post-IPO legal and compliance costs for all public companies substantially. However, the increased regulatory burden is much more material to smaller public companies. There are other reasons for the increase in U.S. accounting costs in addition to SEC regulations, as discussed next.

ACCOUNTING COSTS IN THE UNITED STATES VERSUS INDIA

The author asked these questions of a partner of a Big 4 accounting firm in Mumbai (Bombay), India, on March 21, 2008:

Q1. For an identical accounting service in India versus the United States, how much of a discount should be expected?

A1. The costs of accounting services in India vary significantly between the Big 4 firms and local firms. My guess is that costs

associated with accounting and audit services from a Big 4 firm in India would generally be at a 50–60% discount to comparable services from a Big 4 firm in the United States.

Q2. For an identical company to have an IPO in India versus an IPO in the United States, could you guess how much less the accounting cost would be in India by percentage?

A2. My guess is that the accounting cost would be lower by approximately 65–75%.

Q3. For an identical company that has an IPO in India versus the United States, could you guess how much less the accounting cost would be in India for yearly accounting services subsequent to the IPO? Please use percentages.

A3. My guess is that the cost would be lower by approximately 60–70%.

Obviously, the discount from U.S. accounting costs would vary with each country. If too many IPO companies seek Indian accountants, it is likely that Indian accounting costs will rise in the future.

WHY ARE U.S. ACCOUNTING COSTS SO HIGH?

According to the Final Report of the Advisory Committee on Smaller Public Companies created by the SEC, external audit fees for smaller public companies roughly tripled as a percentage of revenue between 2000 and 2004. Fees for smaller public companies as a percentage of revenue have remained many times higher than for larger public companies over this period.[28]

Numerous factors caused the rise of U.S. accounting costs for public companies. These include:

- The demise of Arthur Andersen LLP
- More rigorous auditing and materiality standards
- Greater complexity of U.S. GAAP compared to international financial reporting standards

- Section 404 of SOX
- Higher compensation for accounting professionals in the United States

The confluence of each of these trends has resulted in the perfect storm insofar as accounting costs are concerned.

DEMISE OF ARTHUR ANDERSEN LLP

The demise of Arthur Andersen LLP was a wake-up call to all accountants and auditors. If the life of a major international accounting firm could be terminated, then all accounting firms were at risk. Each accounting firm tightened its auditing standards and modified the risk profile of the companies with which it would become associated to exclude riskier companies.

Smaller private companies planning an IPO typically have a higher risk threshold than larger private companies planning an IPO. Accounting items that would be immaterial to a larger private company can be very material to a smaller private company. Accordingly, smaller private companies are more frequently rejected for U.S. IPOs by the largest and most prestigious accounting firms.

The demise of Arthur Andersen LLP resulted in the centralization of power within the major accounting firms. Prior to the Arthur Andersen implosion, local accounting partners of major auditing firms could make decisions on significant matters without checking with the national office. That has all changed. Currently, local partners cannot make any significant decisions concerning their audit clients without running it by their "national" office. Although the centralization of power within the national office is understandable, it has resulted in additional layers of accounting review and further increased accounting costs.

The centralization of power in the national office of major accounting firms has not been as significant in dealing with foreign public companies. Many of the foreign offices of major accounting firms are given greater power to make significant accounting decisions. This is partly due to the perception of a less risky environment outside the

United States for accountants. It is also the result of the greater flexibility contained in international accounting standards than in U.S. GAAP, as will be discussed.

MORE RIGOROUS AUDITING AND MATERIALITY STANDARDS

The U.S. corporate corruption scandals embarrassed the accounting profession and created public pressure for more rigorous audits of public companies.

The SEC exacerbated this problem by developing the concept of "qualitative" materiality as well as "quantitative" materiality. At one time accountants believed that items that had an accounting effect less than 5% could be viewed as immaterial. That view was exploded in 1999, when the SEC issued Staff Accounting Bulletin (SAB) No. 99. Under SAB 99, items that were less than the 5% rule of thumb could be viewed as qualitatively material. Take, for example, this passage from SAB 99:

> The staff is aware that certain registrants, over time, have developed quantitative thresholds as "rules of thumb" to assist in the preparation of their financial statements, and that auditors also have used these thresholds in their evaluation of whether items might be considered material to users of a registrant's financial statements. One rule of thumb in particular suggests that the misstatement or omission of an item that falls under a 5% threshold is not material in the absence of particularly egregious circumstances, such as self-dealing or misappropriation by senior management. The staff reminds registrants and the auditors of their financial statements that exclusive reliance on this or any percentage or numerical threshold has no basis in the accounting literature or the law. . . .
>
> . . . The shorthand in the accounting and auditing literature for this analysis is that financial management and the auditor must consider both "quantitative" and "qualitative" factors in assessing an item's

> materiality. Court decisions, Commission rules and enforcement actions, and accounting and auditing literature have all considered "qualitative" factors in various contexts. . . .
>
> . . . Among other factors, the demonstrated volatility of the price of a registrant's securities in response to certain types of disclosures may provide guidance as to whether investors regard quantitatively small misstatements as material. Consideration of potential market reaction to disclosure of a misstatement is by itself "too blunt an instrument to be depended on" in considering whether a fact is material. When, however, management or the independent auditor expects (based, for example, on a pattern of market performance) that a known misstatement may result in a significant positive or negative market reaction, that expected reaction should be taken into account when considering whether a misstatement is material.

SAB 99's identification of possible "market reaction" as another factor in determining materiality to a corporate development created great difficulty in application for accountants and attorneys. The requirement to at least consider market reaction substantially increased the cost of accounting determinations. Accountants must consult with their national office on close issues and in all likelihood will require an attorney's opinion, further increasing the cost to the small U.S. public company.

GREATER COMPLEXITY OF U.S. GAAP

Corporate corruption scandals have also resulted in greater pressure on U.S. accounting standards to permit fewer choices by management. According to a Report on a Survey of Audit Committee Members conducted by the Center for Audit Quality, an affiliate of the American Institute of CPAs, 78% of those audit committee members surveyed thought that audited financial statements were "too complicated."[29]

The Financial Accounting Standards Board has been active in issuing rule-based accounting standards that rival the U.S. Internal

Revenue Code (Code) in complexity. These detailed standards are designed to limit management choices. However, some of these standards contain major ambiguities. These require further interpretations that create additional complexity. The March 2008 survey of public company audit committee members, conducted by the Center for Audit Quality (an affiliate of the American Institute of CPAs), produced this interesting comment by one audit committee member:

> The current model has intricate rules that are not necessarily based on economics but rather the whims of overly technocratic rule makers, and what compounds the problem is that the investment bankers are smarter and more nimble than the rule maker.[30]

The complexity of U.S. GAAP is compounded by the tendency of the SEC Accounting Staff to strictly interpret the ambiguous wording of GAAP accounting pronouncements and second-guess the determinations of Big Four auditing firms. For example, the SEC Accounting Staff's interpretation of the requirements for segment reporting are so strict that public companies have been forced to create, for accounting purposes, business segments that they never internally use, solely in order to satisfy the SEC accountants.

Experts at the Big Four accounting firms believe that the SEC will ultimately mandate the use of international financial reporting standards (IFRS) for U.S. publicly traded companies due predominantly to the desire to have uniform worldwide accounting standards and in part to the perception that U.S. accounting standards may have become too complex. The SEC's chief accountant stated that the United States will shortly be the only country in the world not using IFRS and that the SEC will have to move toward IFRS by 2011.[31] In August 2007, the SEC published a proposed IFRS roadrap.

IFRS tends to be a more principle-based, rather than rule-based, accounting system and is currently much easier to apply. However, it is likely that IFRS will become more complex, detailed, and rule-based as U.S. GAAP is melded with IFRS.[32]

SECTION 404 OF THE SARBANES-OXLEY ACT OF 2002

Section 404 of SOX requires an auditor attestation report on the internal controls of public companies. The Public Company Accounting Oversight Board (PCAOB) published Auditing Standard No. 2, which, according to at least one SEC commissioner, was ''much too granular''[33] and created a whopping increase in already inflated accounting costs. To its credit, the PCAOB has now substituted a less ''granular'' standard by adopting Auditing Standard No. 5. However, that standard is not inexpensive to apply, particularly for a smaller public company.

The SEC has postponed the auditor attestation report provision of Section 404 for smaller public companies for a number of years. However, it seems clear that at some point it will be applied and will significantly increase the costs of being a public company in the U.S.

IPO standards adopted outside the United States have generally rejected the auditor attestation requirement of Section 404. In speaking to officials in India and China, it seems clear that they have no intention of inflicting the Section 404 fiasco on their public companies. Likewise, the London Stock Exchange, including the AIM, has not adopted Section 404 requirements. In fact, the marketing literature for the AIM touts the absence of Section 404 as a major advantage of that market.

The corporate corruption scandals that motivated SOX were the result of fraud by chief executive officers (CEOs) and chief financial officers (CFOs). It is unclear how Section 404 mitigates this risk, since internal controls can be overridden by the CEO or the CFO. The SEC has conceded as much in SEC Release No. 33-8810 (June 27, 2007), which contains this revealing comment:

> ICFR [internal control over financial reporting] cannot provide absolute assurance due to its inherent limitations; it is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. *ICFR also can be circumvented by collusion or improper management override.* Because of such limitations, ICFR cannot prevent or detect all misstatements,

> whether unintentional errors or fraud. However, these inherent limitations are known features of the financial reporting process, therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk. (Emphasis added.)

Despite this concession, the SEC has, to date, rejected the recommendation of its own Advisory Committee on Smaller Public Companies that certain small public companies be exempted from the requirement for an auditor attestation report on internal controls under Section 404 until a ''framework for assessing internal control over financial reporting for such companies is developed that recognizes their characteristics and needs.''[34]

Is it possible that public company requirements outside the United States will ultimately include an auditor attestation report on internal controls? Anything is possible, especially if there is repetition of international corporate corruption scandals, such as Parmalat. However, even if the standards are tightened in the future, it is doubtful that regulators outside the United States will repeat the same mistake as the U.S. regulators.

HOW TO IMPROVE THE COMPETITIVENESS OF THE U.S. CAPITAL MARKETS

It is important for both U.S. politicians and regulators to recognize that the world is increasingly ''flat'' insofar as the capital markets are concerned. While no one disputes the necessity of reasonable regulation of the capital markets, such regulation must take into account the potential off-shoring of the capital raising process.

Outside of the United States, small companies can raise substantially less than $5 to $10 million of capital from the public and still have their stocks traded on the country's stock exchange. For example, in October 2007, Allied Computers International (Asia) Limited engaged in the business of assembling and marketing laptop computers, had an IPO on the Bombay Stock Exchange (BSE), and raised approximately $1.5 million, with a market capitalization after the IPO of less than $6 million.

To be competitive in an increasingly flat world, the United States must develop a similar system. The SEC should encourage the major U.S. exchanges to develop a junior venture exchange similar to the AIM or the Canadian TSX Venture Exchange (see Chapter 9).

The SEC formed an Advisory Committee on Smaller Public Companies and then failed to adopt most of its recommendations, although it did adopt a few. To make the United States more competitive, the SEC should adopt all of the very modest recommendations contained in the Final Report of this committee.

AUDITOR'S ATTESTATION REPORT ON INTERNAL CONTROLS

Despite the almost universal rejection of requiring an independent auditor's attestation report on internal controls, which is provided for in Section 404 of SOX, the SEC continues to insist on imposing this requirement on smaller public companies. To its credit, the SEC has postponed the effective date of the auditor's attestation report several times.

The SEC has also conceded, as noted, that having good internal controls would not necessarily have prevented top management override of internal controls, such as occurred at WorldCom.

The SEC should continue to delay the requirement of an independent auditor's attestation report on internal controls for smaller public companies until it can determine with certainty that the cost of such a report would be financially immaterial to smaller public companies.

SEC REPORTING REQUIREMENTS

The twenty-first-century corporate corruption scandals proved that adopting more detailed and complex SEC disclosure rules will not prevent fraud. Fraudsters will always ignore SEC disclosure rules. Neither Enron nor WorldCom paid any attention to the SEC disclosure rules. However, the burdensome SEC disclosure rules, some of which were adopted in response to these scandals and SOX, do serve to deter IPOs by small businesses.

The SEC disclosure requirements for small businesses should, in general, not be any more burdensome to the small public company than the AIM disclosure requirements. The SEC would do well to review the AIM disclosure rules for smaller public companies.

There is no reason for the SEC to impose quarterly reporting on small public companies through the Form 10-Q report since most securities analysts never follow small public companies and their stock typically is not listed on major stock exchanges. Indeed, one of the primary justifications for originally requiring Form 10-Q reports was the fact that major stock exchanges mandated the dissemination of quarterly information as part of their listing requirements.[35] Unfortunately, the Form 10-Q report requirement was imposed on small public companies even though they would not otherwise be required by listing rules to supply quarterly information. A semiannual report, such as required by AIM, should be sufficient. If the market insists on quarterly reporting, small public companies will respond to market pressures. Indeed, the SEC required only semiannual reports (Form 9-K) prior to the 1970s.

Similarly, the SEC has expanded the Form 8-K requirement to apply to a significant number of events, including entry into any ''material'' agreements (subject to minor exceptions). Since many agreements that are immaterial to a large company can be material to a smaller company, this requirement and other Form 8-K requirements are more burdensome to smaller public companies.

The SEC should review the annual reporting requirements for AIM-listed companies and attempt to conform its annual report on Form 10-K for smaller public companies more closely to these requirements.

Finally, smaller public companies should be given the option to use international financial reporting standards as an alternative to U.S. GAAP. AIM-listed companies already have this right.

STATE SECURITIES LAWS

Even when the SEC tries to be creative in facilitating capital raising by small private companies, state securities regulators refuse to go

along. For example, in Regulation A offerings (discussed in Chapter 14), which permit a private company to raise up to $5 million during any 12-month period, the SEC adopted a provision permitting the private company to "test the waters" prior to incurring the cost of creating an official offering statement.[36] Unfortunately, securities regulators in many states refuse to adopt a similar exemption, as a result of which the test-of the-waters procedure cannot be used in many states. If SEC wishes to help smaller private companies to raise capital, it should request Congress to preempt state securities laws that interfere with this process.

The SEC needs to remove the barriers to smaller private companies going public through an Internet direct public offering which sold only to accredited investor registered with the SEC under the 1933 Act. This will require the SEC to request Congress to preempt obsolete state securities laws, including those states (e.g., Kansas) that have so-called merit reviews.[37] Many states that are not known as merit review states (such as Pennsylvania) nevertheless use ambiguous words in their statutes to impose merit review, particularly on small business offerings.

The U.S. Congress has already passed legislation that preempts the registration provisions of state securities laws. However, this legislation (Section 18 of the 1933 Act) was limited to companies large enough to be listed on the major U.S. stock exchanges. This left smaller companies that attempted to raise public growth capital at the tender mercy of 50 different state securities laws.

These state securities laws typically are administered by bureaucrats and politically active commissioners who are sensitive to public criticism if securities offerings they review cause investor losses. Consequently, they tend to take a paternalistic view toward securities offerings and have low risk tolerances. Since securities offerings by small businesses are typically risky investments, these state securities laws impose difficult, if not impossible, burdens on small businesses attempting to raise public growth capital, even if these small businesses are willing to fully disclose their risks to investors. Neither Intel nor Microsoft would likely have satisfied the merit review standards during their start-up phases.

Small business has been the engine for employment growth in the United States. We have stifled its ability to raise public growth capital on a national basis because of these state securities laws. Most such laws were adopted in the late nineteenth century and the early twentieth century. While attempts have been made to create uniform state laws (e.g., the Uniform Securities Act), and a number of states have registration by notification or coordination, in the twenty-first century, there is no reason to impose on small businesses that wish to raise public capital nationally the burdensome and expensive requirement to comply with the registration provisions of these laws or to be subjected to merit review. State securities commissions should be confined to enforcing the antifraud provisions of their statutes and should allow public offerings registered with the SEC to proceed without merit review or other interference.

This concludes the discussion of the pros and cons of a U.S. IPO. International IPOs (including AIM IPOs) are covered in Chapters 9 and 10.

Chapters 2 through 8 discuss advance planning techniques for an IPO candidate, regardless of whether the private company is located in the United States or internationally. We begin in Chapter 2 with the requirement to develop impressive management and professional teams. This chapter considers certain U.S. tax issues in structuring equity incentives that may not be applicable to international companies. International companies should consult their own tax advisors for the tax consequences of equity incentives.

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