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The Effect of the JOBS Act on Underwriting Spreads

Usha Rodrigues

INTRODUCTION

Title I of the Jumpstart Our Business Startups Act of 2012 (JOBS Act) aimed to "reopen American capital markets," that is, to stimulate initial public offerings. To that end, it introduced a new category of issuers, so-called emerging growth companies (EGCs), and provided those companies with relief from significant features of the securities laws, so as to entice them into the public market.

It has been over a year since the passage of the JOBS Act, and information concerning its impact has begun to come in. Drawing on that data, this Article examines the effect of certain provisions of Title I on underwriter fees.

At the outset, some definitions are in order. An underwriting investment bank (or, more precisely, a group of banks, known as a syndicate) serves as the intermediary between an issuer and the investors who purchase shares at the initial public offering, or IPO. In virtually every IPO transaction, the underwriter buys shares from the issuer at a discount, known as the underwriting spread, underwriter discount, or gross spread, and then sells them to the public at the offering price. Underwriters provide a number of services: they help prepare and vet registration statements to be filed with the SEC; they iron out the details of conducting the offering (e.g. price, size, timing); and they market it, contacting interested investors and soliciting orders from them.

Most IPOs involve a "firm-commitment" offering, where the underwriter commits to buy all the shares of the offering to resell to the public. Under

1 Associate Professor, University of Georgia School of Law. I thank the organizers and participants of the Kentucky Law Journal 2013 Symposium, The Securities Act of 1933 at 80: Does It Provide a Fair and Efficient Access to Capital?, held at the University of Kentucky College of Law on October 11, 2013, especially organizers Rutheford B Campbell and James Cox, and participants at University of Georgia's "First Monday" series, particularly Peter "Bo" Rutledge. Thanks also to Jay Ritter and Dan Coenen for helpful comments. Jordan Seal and Miranda Owens provided valuable research assistance. Special thanks to Mike Stegemoller for continued advice and counsel on this project. Mistakes are my own.


3 See id. § 19:2:1[B], at 40 ("[T]he underwriters purchase the shares from the company at the IPO price, less a discount called the "underwriting discount" or "gross spread . . . "); Black's Law Dictionary 1533 (9th ed. 2009) (defining "spread" in the investment banking context and offering "gross spread" and "underwriting spread" as synonyms).

4 See Westenberg, supra note 2, § 19:2:1[B] (explaining the roles of bank personnel in underwriting).


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governing law, however, underwriters cannot enter into binding subscription agreements with purchasers prior to the offering. As a result, underwriters bear the risk that the offering will not sell.

Underwriters' official compensation for bearing that risk and for shepherding the issuer through the IPO process comes from the gross spread—that is, the difference between the discounted price the underwriter pays the issuer and the "sticker price" at which the underwriter sells the offering to the public. For the past two and a half decades this price has clustered at a single percentage: 7%. Indeed, despite "widely accepted" fixed underwriting costs, 90% of IPOs from 1995–1998 had spreads clustered at exactly 7%. Chen and Ritter first documented the puzzle of the 7% spread in 2000. In that paper, they hypothesized that this 7% spread was above competitive levels, the product of implicit collusion among underwriters. Subsequent finance literature confirmed the presence of a sticky 7% spread, although some observers disputed the claim that this commonality signaled collusion.

The passage of the JOBS Act affords an opportunity to examine the effect of a legal change on the costs of going public. If we assume that Title I is operating as intended, it should now be cheaper and easier to take issuers public. If we also assume that the underwriting market is competitive and that pricing is flexible, one would expect to see a decline from the 7% spread in the post-JOBS Act world.

Of course, the forgoing assumptions are big ones. Title I’s provisions may not be effective in bringing down the costs of IPOs; thus, the underwriter spread may be unaffected. Or the provisions may be effective in bringing down the cost of taking a firm public, but the savings may not be reflected by a reduction in the gross spread, either as a result of collusive behavior or because
underwriter pricing is inflexible for other reasons. Finally, it might be that Title I's provisions are effective, but the market is still in the process of internalizing them. That is, the existing data might be too recent to reflect a change that will ultimately occur.

With these caveats firmly in mind, this Article seeks to provide a first-cut answer to the question of whether Title I has had an impact on the underwriting spread. I isolate three separate ways in which EGCs should benefit from relaxed rules Title I put in place that seem to make the underwriters' job easier: 1) issuers are now allowed to file draft registration statements with the SEC; 2) they may “test the waters” by communicating with qualified institutional buyers and accredited investors to determine their interest in an offering prior to its launch; and 3) they are allowed to provide two, rather than three, years of financial statements.14

I examine spreads on 125 firm-commitment IPOs from April 10, 2012 to July 27, 2013, omitting closed-end funds, American Depository Receipts (ADRs), real estate investment trusts (REITs), unit offerings, financial institutions, and best efforts offerings from the sample. My hypothesis is that various JOBS Act provisions have made it cheaper, easier, and less risky to go public. If they have, and if no collusion is present, gross spreads of EGCs should fall below 7%.

I discuss various characteristics of my sample in Part III, but the punch line is: There is a positive and significant relationship, at the 10% level, between the filing of a draft registration statement and a spread under 7%. Controlling for size (which the literature universally acknowledges to be a factor in pricing, given economies of scale in underwriting), the relation is significant at a 5% level.

The ultimate lessons of the findings are multivalent. On the topic of stickiness, it is evidence that underwriter pricing is flexible, which in turn suggests a lack of collusion, at least in the post-JOBS Act environment. It remains to be seen whether post-JOBS spreads will find a new equilibrium point around which to cluster.

Secondly, the data provide an opportunity to give the JOBS Act a preliminary exam. Given the concrete effect on underwriting costs, it seems that Congress got something right: the ability of an issuer to file draft registration statements appears an effective means of easing the IPO process. The data do not show an effect that results from the law’s reduction of the number of years for which financial statements must be supplied. To be sure, this fact does not necessarily mean that this provision is ineffective at spurring IPOs. Instead, it may be that this provision makes IPOs more attractive to issuers, but is a topic to which underwriters are indifferent.

Thirdly, the data do show a relationship between the filing of a draft registration statement and reduced underwriting fees. Importantly, they suggest

14 Unfortunately, due to limitations in the data, I have been unable to determine with certainty which issuers have made use of their newfound ability to test the waters.
that this ability to obtain a “free look” from the SEC is making EGC IPOs cheaper and easier.

The rest of the Article proceeds as follows. Part I describes the old system for going public and the central role the underwriting banks play in it. This Part also highlights the changes the JOBS Act wrought, focusing specifically on those changes that might make the underwriter’s job easier and less risky. Part II reviews the literature surrounding the underwriter discount, describing both the original Chen & Ritter study and subsequent work that offered explanations apart from collusion for the sticky 7% spread. Part III presents the data I have collected and findings they support. Most importantly, they suggest that the Title I’s introduction of the draft registration statement is a valuable feature of the post-JOBS Act securities laws.

I. The JOBS Act’s Changes to the IPO Process

The JOBS Act has changed the IPO landscape. Title I of the JOBS Act aimed to make going public easier for emerging growth companies, defined as companies with total annual gross revenues of less than $1 billion (after inflation adjustments to be made every five years by the SEC) during their most recently completed fiscal year.15 Several provisions in particular seem to make the job of the underwriter cheaper, easier, and less risky for EGCs than it was in the past. First, EGCs may confidentially submit draft registration statements for SEC review prior to going public.16 Second, EGCs and their underwriters can communicate with qualified institutional buyers and accredited investors to determine their interest in the offering (“testing the waters”).17 Third, registration statements for the IPO need only include two years of audited financial statements (down from the three years required for non–EGCs).18

Before one can appreciate the changes the JOBS Act wrought on the offering process, it is necessary to understand a typical IPO timeline in the pre–JOBS Act world. Before JOBS, a company and its bank would take four to six weeks to prepare a registration statement, including a prospectus, to file

16 Id. § 77(f)(1).
17 Id. § 77e(d).
18 Id. § 77g(a)(2) (2012). Other important JOBS Act accommodations are relevant only after the company goes public: the exemption from the internal controls audit, streamlined executive compensation disclosure, and extended phase-in for changes in generally accepted accounting principles. See Securities Act of 1933, 15 U.S.C. § 7262(b) (2012) (exempting EGCs from internal evaluation and control requirements); JOBS Act, Pub. L. No. 112–106, § 102(a)(3), 126 Stat. 306, 309 (2012) [hereinafter JOBS Act] (exempting EGCs from compensation disclosures that could be required by Dodd–Frank); Securities Act of 1933, 15 U.S.C. § 77g(a)(2) (2012) (requiring EGCs to adopt new accounting procedures only if and when “companies that are not issuers” are required to do so). Because these come into play only after the IPO, I presume they would not ease the role of the underwriter in any appreciable way, and so I ignore them for the purposes of this study.
with the SEC. The registration statement described the company’s business and prospects, management’s background, legal and accounting issues, financial statements, and the details of the offering itself. The accountants, underwriters, and counsel for both the underwriter and the issuer conducted “due diligence” to ensure that each statement in the prospectus was accurate.

After filing the registration statement, the company entered a quiet period, in which federal securities laws restricted the information the company could release to the public. Once the SEC made comments on the registration statement, the company had to wait longer still as it responded to SEC requests and awaited word on whether further amendments to the registration statement would be necessary. Once the company was sure that the SEC had not identified any large obstacles to going public, it would finalize a road show, which consisted of a number of meetings with large potential investors in a number of cities during a two- or three-week period. Web presentations were also sometimes made available to institutional investors. Generally the issuer also filed an electronic version of the road show presentation with the SEC. As the road show moved along, the underwriters built their book of subscriptions, typically looking for four-to-five times oversubscription rates. If all went well, at the close of the road show, the managing underwriters advised the issuer’s pricing committee about the number of shares and price at which they were willing to purchase the shares to offer to the public. The SEC would then officially declare the registration statement effective, and the stock would be sold the next day.

In the real world public offerings rarely ran this smoothly. Problems could emerge at any stage of the process. Some problems were out of the issuer’s hands; for example, the IPO “window” could close at any time, meaning that market conditions had changed to make it an inhospitable climate for IPOs of all kinds. The SEC could take serious issue with statements in the registration

20 See Hazen, supra note 5, § 3.2 (detailing process of preparing and submitting a registration statement).
21 See id. § 3.2, at 303 ("Each of the participants in the preparation of the registration statement has a duty of reasonable investigation.").
22 See Allison et al., supra note 19, at 34 (introducing the “waiting period” portion of an IPO timeline).
23 See id. (describing receipt of and response to SEC “comment letters”).
24 See id. at 63 (generalizing steps in conducting a road show).
25 See id.
26 See id. at 35, 41-42 (explaining steps between the road show and an effective offering).
27 See id. at 35, 41.
28 See Westenberg, supra note 2, §§ 1:3, 1:3.1 (describing the “window” and listing factors affecting IPO timing).
In the process of due diligence, the accountants could discover weaknesses or inaccuracies in the financial statements, and the lawyers could uncover legal issues that need to be resolved. During the road show, the underwriters might determine that potential buyers were cool to the issuer's "story" and abandon the offering altogether. The SEC's Edgar database is littered with registration statements from companies that failed to go public; indeed, many companies that eventually did go public had a failed registration statement along the way.

By statutory design the underwriter bears a large measure of these risks. Firm commitment underwriters address this risk by building a "book" of subscriptions, often oversubscribing the actual offering amount. Thus, the underwriter's work benefits both the issuer and potential investors. For the issuer, the underwriter makes a market. For buyers, underwriters provide an investment opportunity while contributing to due-diligence work that maximizes the information potential buyers receive.

Pricing an initial offering is a risky business, since there is by definition no pre-existing market price to use as a reference point. In addition, these transactions are fraught with informational asymmetries; issuers know more about their future outlook than do potential investors, and investors know more about the terms on which they will invest. As repeat players, investment banks can act as informational intermediaries or, as William Wilhelm terms them, "coordinators of large-scale, strategic information networks." Moreover, underwriters serve a bonding function because of the legal obligations they assume in the offering process. Underwriters are strictly

29 See id. §§ 17:3.3, 3.5 (listing types of SEC comments to registration statement submissions).
30 See, e.g., HAZEN, supra note 5, § 3.2 (providing examples of legal challenges that may arise in preparing a registration statement).
34 See WESTENBERG, supra note 2, § 19:7.2[B] (listing examples of diligence).
36 Id.
liable for any misstatements in the registration statement, but they have a due diligence defense: they are not liable if, after reasonable investigation, they have an actual belief based on reasonable grounds that the statements were true and not misleading. Thus purchasers can take comfort in knowing that the underwriter has vetted the registration statement for accuracy and is a “deep pocket” on the hook for misstatements in many cases.

Having reviewed the pre-JOBS Act IPO process, and the underwriting bank’s central role in it, we can return to Title I’s accommodations with a greater appreciation for how they changed the public offering process.

First, emerging growth companies’ post-JOBS Act ability to communicate confidentially with the SEC prior to filing should make it easier to go public and ease the underwriting process as well. If the SEC has serious reservations about the issuer’s early disclosures, the underwriter can learn about those reservations and address them before embarking on the offering. Alternatively, the underwriter can decide that the issuer is not a good candidate for underwriting at all, thus saving the expense of further drafting, due diligence, and a road show for an offering destined to falter or fail.

To the extent that the 7% discount includes an extra allowance to account for the possibility of


38 The 1933 Act states that “no person, other than the issuer, shall be liable” unless the issuer can prove that “after reasonable investigation,” he had an actual belief based on reasonable grounds that the statements in the registration statement were true and not misleading when the registration statement became effective. 15 U.S.C. § 77k(b)(3)(A). See also infra notes 54–58 and accompanying text (discussing affirmative defenses available to underwriters).


ultimate failure, underwriters can reduce this allowance in a post-JOBS Act world. The comfort that SEC review provides should result in fewer ultimately aborted offerings progressing farther than they ought to. Road shows are expensive; to reach an ideal level of subscriptions, the underwriter and issuer devote considerable resources, including human capital, toward reaching and enticing investors. Thus, if confidential filings help underwriters diagnose problems early then they can help underwriters pull doomed offerings before road show and other sales expenses are incurred. Moreover, if many of these underwriting costs decline, there is less need for underwriters to cover the cost of failed offerings, so that we should expect the ultimate underwriting discount to decrease accordingly. In short, in a competitive market we would expect to see a reduction in gross spreads.

The JOBS Act’s “testing the waters” provision should reduce gross spreads as well. A chief task of the underwriter is to sell the offering. Limited by the restriction on obtaining firm subscription agreements, underwriters must inevitably guess at the market price for new issues; usually the result is that offerings are oversubscribed to avoid the “Facebook” problem of offering too many shares at too high a price for the market. A fear of overpricing results in the opposite, and much more common, problem of underpricing shares.

In the pre-JOBS Act world, firms were not allowed to sell securities before the registration statement became effective, and were limited in engaging in post-filing communications with customers as well.

43 See Morris Mendelson, Underwriting Compensation, in Friend, Longstreet, Mendelson, Miller and Hess, Investment Banking and the New Issues Market 394, 398 (1967) (describing the risk that “after much work has been done [by the underwriter] in the preparation of an issue, a prospective issuer may decide against issuing the security under consideration because of adverse changes in the market or some other development” as one of the more common “occupational hazards” affecting underwriters’ general overhead costs).

44 See Stephen C. Blowers et al., The Ernst & Young Guide to Taking Your Company Public 91 (1995) (highlighting the “considerable expense” associated with road shows, especially in terms of “the heavy commitment of executive time required for an initial public offering”).

45 See Lagorio-Chaikin, supra note 41 (“[Confidential filing] makes it easier for a company to quietly back away from an IPO if the [SEC’s] response isn’t sunny.”).

46 See Westenberg, supra note 2, § 19:1 (“In a firm-commitment underwriting, the company sells shares to the underwriters, which then distribute the shares to the public . . . .”).


48 See Allison et al., supra note 19, at 8.

49 See Travlos, supra note 33 (criticizing Facebook’s offering for its inflated IPO price and its related failure to adequately subscribe to the offering).


The JOBS Act allows firms to test the waters by communicating with accredited investors and qualified institutional buyers prior to the road show—prior even to filing with the SEC—about their potential interest in the offering.\footnote{52} As with the confidential SEC filing, this newfound ability for the underwriter to gauge investor demand before embarking on the costly offering process should cut down on fruitless due diligence and abortive road shows, thus reducing overall costs to the underwriter.\footnote{53} In a competitive environment, this reduction should translate into a lower spread for completed offerings.\footnote{54}

Finally, reducing the number of audited financial statements that the issuer must file to two years' worth from three might simplify the underwriters' work. Under the Securities Act, underwriters are liable for material misstatements or omissions contained in the registration statement,\footnote{55} unless one of two affirmative defenses apply.\footnote{56} The availability of each defense depends primarily on whether the inaccurate information was "made on the authority of an expert."\footnote{57} Although the Act does not define an "expert," courts have held that accountants qualify, and that underwriters can rely on information prepared by them without fear of liability.\footnote{58} However, this protection only extends to information to which an expert has actually applied his or her expertise. For example, courts and the SEC have distinguished between audited annual financial statements incorporated in registration statements and "comfort letters" issued as part of changes to the offering process and compliance challenges (contrasting pre-JOBS limits on communications with the new test-the-waters allowance).

\footnote{52} § 77e(d) ("[A]n emerging growth company or any person authorized to act on [its] behalf . . . may engage in oral or written communications with potential investors that are qualified institutional buyers or institutions that are accredited investors . . . to determine whether such investors might have an interest in a contemplated securities offering, either prior to or following the date of filing of a registration statement . . .").

\footnote{53} See Moch, supra note 42 (connecting heightened investor attention and ultimate oversubscription to the ability to test the waters before conducting a formal road show); see also \textsc{Katrina Ellis et al., A Guide to the Initial Public Offering Process} 3 (1999), available at http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.198.840&rep=rep1&type=pdf (associating 20% of the gross spread with underwriting expenses, such as legal costs and conducting the road show).

\footnote{54} But see Jessica Holzer, \textit{SEC Official: Confidential Filings Popular After JOBS Act}, \textit{Wall St. J.} (Feb. 22, 2013, 12:41 PM), http://blogs.wsj.com/cfo/2013/02/22/sec-official-confidential-filings-popular-after-jobs-act/ ("[T]he SEC is hearing anecdotal reports that relaxed restrictions on the use of IPO research isn’t being broadly adopted. Meanwhile, few companies are taking advantage of the right to hold discussions with investors . . . to gauge their interest . . .").

\footnote{55} Securities Act of 1933, 15 U.S.C. § 77k(a)(3) (2012); see also Leahy, supra note 37, at 421-22 (describing underwriter liability for statements in the registration statement).

\footnote{56} See § 77k(b)(3); see also Leahy, supra note 37, at 422.

\footnote{57} § 77k(b)(3)(A)–(C).

of the due diligence process: the only portions of a registration statement that may be safely relied upon are those actually prepared or certified by an accountant. Thus, underwriters can rely on certified annual financials attached to a registration statement, but must conduct a reasonable investigation into other forms of information—such as interim financials or management projections—to be insulated from liability. To the extent that issuer filings cover only two (rather than three) years, it, therefore, may follow that underwriter reviews of issuer registration statements will become less complicated and costly.

Anecdotal reports suggest, however, that issuers may not be availing themselves of the opportunity that the JOBS Act affords them to disclose only two, rather than three, years of audited financial statements. In any event, the need to deal with two years of financial statements probably reduces underwriters' exposure only marginally, if at all. Indeed, if issuers supplement their two years of audited financial statements with the disclosure of other financial information, such as unaudited, and thus non-expertized statements, the effect will be to increase underwriter liability by providing them with more material for which they must conduct due diligence. Thus one area of interest is the type and amount of financial information issuers are disclosing under current law.

Having reviewed both the evidence on clustering of U.S. gross spreads at 7% and the changes that the JOBS Act has wrought on the IPO process, we are ready to tackle the central question of the Article: what impact, if any, the JOBS Act has had on gross spreads.

II. Prior Literature

At the outset, it is important to note that the Financial Industry Regulatory Authority ("FINRA") regulates underwriter compensation. FINRA applies a secret formula to determine whether the proposed compensation is 'fair and reasonable'; if it is not, the offering may not go forward. FINRA, however, is concerned with setting an upper ceiling on the spread, and generally accepts a

59 See In re Software Toolworks Inc. Sec. Litig., 50 F.3d 615, 623 (9th Cir. 1994) ("An underwriter need not conduct due diligence into the 'expertised' parts of a prospectus, such as certified financial statements."); In re WorldCom, 346 F. Supp. 2d at 666 (contrasting certified annual financial statements with interim financial information).

60 See, e.g., Holzer, supra note 54 (reporting an SEC official's impression that companies are not taking full advantage of the law's looser financial reporting standards); Emily Chasan, Meet the JOBS Act's Job-Free Companies, WALL. ST. J. (June 4, 2012, 7:44 PM), http://online.wsj.com/article/SB100014240527023035064045774439893828956.html (reporting an EGC's decision not to "relax its disclosure or compliance with Sarbanes-Oxley" without better knowledge of investor preferences for more financial information).


62 Id.
spread of 7%.  

Chen and Ritter first identified this clustering in their ingeniously titled "The Seven Percent Solution," which examined IPOs from 1985–1998. They raised the question whether the 7% spread was artificially high, and whether it was the product of implicit collusion or a lack of competition in pricing.

Abrahamson, Jenkinson, and Jones updated the Chen and Ritter study in 2010 and found even greater convergence around 7% between 1998 and 2007. Like Chen and Ritter, they also highlighted the existence of lower European IPO fees, which did not cluster around any number. However, Torstila found evidence of clustering in foreign markets, including some clustering more pronounced than in the U.S. Torstila also cited the existence of clustering coupled with a low gross spread as evidence that clustering does not necessarily imply collusion. He suggested, nevertheless, that the existence of large U.S. IPOs with a 7% gross spread qualified as "suspect."

There are a variety of explanations for price inelasticity in gross spreads. Robert S. Hansen proposed an efficient contract theory for the dominant 7% figure. Hansen emphasized that the IPO contract has many facets; for example, underpricing of the offering could lead to higher compensation despite a nominal price of 7%. He suggests that "7% plus" might be a more accurate description of the contract.

More recently, Fernando et al. found evidence of price differentiation based on underwriter reputation. They concluded that higher reputation banks receive significantly higher spreads than those with lower reputations.

To summarize, pre–2012, several studies found significant clustering of the underwriter discount around 7%. Several factors suggest that this clustering might be the product of anti–competitive forces; the bare fact of clustering itself, and the presence of lower fees and a lack of clustering for European IPOs. Hansen proposes an alternate explanation for clustering, postulating that other levers of underwriter compensation may adjust in a competitive manner.
despite the near-constant 7% fee.\textsuperscript{75} Fernando et al. offer some evidence that the clustering masks price differentiation based on bank reputation.\textsuperscript{76}

### III. Data

Chen and Ritter originally examined the spreads on firm commitment IPOs from January 1985 to January 1998 covered in the Securities Data Company's (SDC) New Issues database.\textsuperscript{77} They eliminated closed-end funds, ADRs, REITs, and unit offerings from the sample.\textsuperscript{78} They further restricted the sample to equity IPOs with domestic gross proceeds of over $20 million because the spreads for small offerings are “much higher due to the diseconomies of scale.”\textsuperscript{79} Chen and Ritter excluded overallotment options, and expressed all dollars in terms of 1997 purchasing power.\textsuperscript{80} As described above, Chen and Ritter found evidence of the clustering of spreads around 7%.\textsuperscript{81}

Abrahamson, Jenkinson, and Jones revisited Chen and Ritter’s study after ten years, and also compared U.S. underwriting spreads with European ones, applying the same exclusions and using a cutoff of $25 million, the 2007 equivalent of $20 million in 1997.\textsuperscript{82} They discovered that clustering at 7% had become even more prevalent since 1998.\textsuperscript{83} They further found new evidence of clustering in larger IPOs, reporting that 77% of offerings sized between $100 and $250 million clustered at exactly 7%.\textsuperscript{84}

Seeking to take the same approach as these earlier studies, I ran a search in SDC of all firm-commitment IPOs over $29 million (the 2012 equivalent to $20 million in 1997 dollars) from April 5, 2012 (the JOBS Act enactment date) through July 27, 2013. I excluded all unit issuers, REITs, closed-end funds, and ADRs. I required that the primary exchange be in the United States. As is customary in the literature, I excluded banks, savings and loans, and asset management companies with an SIC code beginning with six.

My hypothesis is that various JOBS Act provisions make it cheaper, easier, and less risky to go public. That was the intent of the statute. Therefore, if no collusion is present, gross spreads of EGCs should fall below 7%. If the underwriting spread holds constant at 7%, this indicates that collusion persists in the face of lower underwriting costs. There may have been some initial uncertainty associated with the transition to post-JOBS Act underwriting, so
an alternate hypothesis is that the underwriting spreads immediately after the Act hold constant, and then drift down over time as savings materialize and banks begin to compete on spreads. In other words, a limitation of these data is their recency. We may see more change as more time passes.

Alternatively, a steady 7% might indicate that the JOBS Act provisions were ineffective. On balance, however, this result seems unlikely. The provisions, particularly testing the waters and allowing for a “free look” from the SEC via draft registration statement, seem likely to have succeeded in their goal of making the IPO process cheaper and easier.85

Finally, Hansen’s work suggests that there might be other reasons for clustering: 1) deviations from the norm might raise suspicions about issuer value (underwriters might be willing to overvalue a firm in exchange for a generous spread); 2) uniform spreads might reduce moral hazard by encouraging underwriter placement effort; or 3) a fixed figure might lower negotiation costs, particularly because the spread is negotiated together with other offering details, such as the offering amount, the overallotment, and the offer price.86

To maintain the constant gross spread, other portions of the underwriter’s compensation, namely underpricing, may flex in a more competitive manner. Were this theory true, we would expect to see less underpricing in EGCs in the face of a constant gross spread.

If underwriting spreads drop, but cluster around some lower percentage, the drop is evidence that the JOBS Act has driven down costs. But the clustering might indicate that collusion is occurring once more and that the market has converged on a lower spread as the appropriate one. Finally, if underwriting spreads drop but do not cluster, there is evidence the JOBS Act drove down the costs of going public and collusion may not exist, perhaps because of the shake-up of industry practice brought about by the Act.

One challenge of researching the effect of these provisions is that issuers appear to be employing a “cafeteria style” approach to the EGC provisions: they pick and choose which of the accommodations they will use.87 For example, a company might qualify as an EGC company, yet voluntarily disclose three years of financials rather than the permitted two. Or it may avail itself of its new “test the waters” ability, but elect not to provide confidential draft registration statements for SEC review. This heterogeneity in EGCs requires the tracking of different variables in the sample. Another hypothesis of this Article is that EGCs making use of more accommodations will have a lower spread than those that make use of fewer accommodations.

85 But see 2013 BDO IPO Outlook, BDO 5, http://www.bdo.com/download/2432 (last visited Mar. 31, 2014) (observing that only 29% of capital markets executives at leading investment banks thought the JOBS Act would be effective at increasing IPOs, while 18% thought it was too early to tell).

86 See Hansen, supra note 13, at 315–16.

87 See Holzer, supra note 54 (“[An SEC official] indicated that some of the law’s provisions are proving more popular than others.”).
Accordingly, in the sample I separate EGC-filing companies from those that do not opt to file as EGCs. Not every issuer that qualifies elects to file as an EGC. Companies identify themselves as EGCs on the cover page of the registration statement, so identification is easy.88 With regard to EGC filers, I track which companies disclose more than two years of financials. Again, a simple review of the registration statement reveals this information.

Tracking which issuers avail themselves of confidential review of registration statements prior to filing is a little more complicated. From the passage of the JOBS Act, the SEC required companies that elect to go forward with an offering after a confidential review to file the draft registration statement publicly.89 The current practice is for the issuer to file the draft registration statement as a “DRS.”90 Accordingly, where such a tag occurs in the SEC’s Edgar database, it is clear that the company availed itself of the confidential review accommodation. Initially however, the SEC required issuers to attach the draft registration statement as an exhibit to the first filed registration statement, generally as exhibit 99.1 or 99.2.91 Therefore, where there is no DRS designated filing, I review the first S-1 filed to see if a draft registration statement is attached as an exhibit. Using this method, I am reasonably confident that I am capturing most instances in which the issuer submitted a draft registration statement for review.

Unfortunately, I have no such faith with respect to the “test the waters” provision. If in correspondence the staff asks an issuer whether it has communicated with any qualified institutional buyers (QIBs) or accredited investors, and the issuer responds affirmatively, I am able to count such instances of use of the provision. Indeed, there have been reports that the SEC “routinely” asks for copies of written test-the-waters materials. One law firm advises only providing these materials in hard copy (rather than through EDGAR), requesting confidential treatment, and asking the SEC staff to return the materials.92 Thus, there is no way to be certain I am capturing all, or even most,

89 See Securities Act of 1933, 15 U.S.C. § 77f(e)(i) (2012) (requiring that the “initial confidential submission and all amendments thereto shall be publicly filed with the Commission not later than 21 days before the date on which the issuer conducts a road show”).
91 See Townsend, supra note 42 (“These prior confidential submissions should be included as exhibits to the company’s later publicly filed registration statement, if any.”).
92 Although the SEC does not require test-the-waters materials be submitted independently, in practice, the Staff often requests that “written materials” used for test-the-waters be submitted for review with the registration statement. See Corporate Finance Alert: The JOBS Act: What We Learned in the First Nine Months, Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates
such uses.\textsuperscript{93} Indeed, I found only four such instances, which I report here but do not include in the reported data.

Finally, Title I of the JOBS Act provides other benefits to EGCs, including exemptions from onerous executive compensation disclosure requirements and internal controls review.\textsuperscript{94} While these provisions arguably make being public more attractive for a private company, they do not make the process of going public any easier. Thus I omit them from this study.

In sum, I examine spreads on 125 firm commitment IPOs from April 5, 2012 (Title I's effective date) to July 27, 2013. Closed-end funds, ADRs, REITs, unit offerings, financial institutions, and best efforts offerings are excluded from the sample. Finally, I exclude the Facebook IPO. Facebook went public within the period, but it was an outlier in many ways. Its offering size of $16 billion was almost eight times the size of the next largest offering, and its spread was commensurately tiny, only 1.10%.\textsuperscript{95} I exclude it lest it skew the results unduly.

Table 1 reports the number of offerings by issuer type (EGC or non-EGC), offering size, and gross spread. As a reminder, looking at the 1998–2007 period, Abrahamson, Jenkins, and Jones describe an average gross spread of 6.98%, with 95.4% of moderate IPOs and 77% of IPOs sized between $100 and $250 million reporting exactly 7%,\textsuperscript{96} an increase in the clustering that Chen and Ritter first reported.

The post-JOBS Act data show that clustering at the 7% level continues unabated. Table 1 shows that overall, moderate-size IPOs (with proceeds between $29 and $109.99 million) exhibit substantial clustering: 94.2% (compared to 95.4% in the 1998–2007 period). In larger IPOs (with proceeds between $110 and $277 million, the 2012 equivalent of Abrahamson's next grouping) there is less clustering, with 66.7% of the sample exhibiting a spread of exactly 7%, and the remaining 33.7% employing a spread averaging 6.33%.

This finding is consistent with the conventional wisdom that economies of scale should operate on larger offerings, and the gross spread should decrease. Chen and Ritter's study indeed found such economies of scale, but they were less evident in the Abrahamson study.\textsuperscript{97}

\textsuperscript{93} Author's discussion with the SEC Division of Corporation Finance confirms the same.


\textsuperscript{96} Abrahamson et al., supra note 12, at 2063–64.

\textsuperscript{97} Chen & Ritter, supra note 9, at 1114; Abrahamson et al., supra note 12, at 2064.
Delving further into the data, I compare EGCs and non-EGCs. Table 1 shows that the IPOs for moderate-size EGCs demonstrate a significant amount of clustering at the 7% spread: 95.4% of the EGC IPOs had underwriter discounts of exactly 7%—the very number Abrahamson, Jenkins, and Jones found in their study. The clustering is less pronounced at large IPOs, with only 76% of EGC IPOs in this category exhibiting gross spreads of exactly 7%, but again, this number closely tracks Abrahamson's finding of 77% clustering at this offering range.98

The three moderate EGCs with sub-7% gross spreads appear to be outliers, making up only 4.6% of the sample; two of the three merit further explanation. SolarCity started out with an offering price range of $13 to $15 before being cut to an offer price of $8.99 Initially, it was expected to raise $141 million gross, but with the change in the offer price the ultimate offering proceeds were expected to raise only $92 million.100 WCI Communities, Inc. filed with an initial price range of $21 to $23 before being cut back to $15, and went from expected gross proceeds of $185 million to $102.3 million.101 Thus, two of the three sub-7% moderate-size EGCs started as larger offerings (at which point the gross spread may have already been negotiated) before being cut back in size to the moderate category.

The data relating to non-EGCs are striking, but the numbers are too small to permit us to extrapolate much. First, it is clear that most moderate-size offerings are opting for EGC status. Of the sixty-nine moderate-size issuers, only four plumped for non-EGC treatment—and one of those, Erickson Air-Crane, went public on April 10, 2012, the first IPO following the JOBS Act’s passage. Presumably the die was already cast in favor of a traditional IPO at that point. The vast majority (94.2%) of moderate-size IPOs are now EGCs.

Table 2 describes the prevalence of various JOBS Act accommodations in the EGC portion of the sample, composed of ninety-four firms. The data show that 58.5% of all EGC IPOs make use of the draft registration statement accommodation. The ability to disclose two, rather than three, years of financials has proven less popular, with only 28.7% of firms making use of that accommodation. Smaller offerings appear to be more likely to disclose

98 Abrahamson et al., supra note 12, at 2064.
99 Compare SolarCity Co., Registration Statement under Securities Act of 1933 (Form S-1/A) 2 (Nov. 12, 2012) ("It is currently estimated that the initial public offering price per share will be between $13.00 and $15.00."), with SolarCity Co., Registration Statement under Securities Act of 1933 (Form S-1/A) 3 (Dec. 12, 2012) ("It is currently expected that the initial public offering price will be $8.00 per share.").
100 SolarCity Co., Registration Statement under Securities Act of 1933 (Form S-1/A) 3 (Dec. 12, 2012).
101 Compare WCI Communities, Registration Statement under Securities Act of 1933 (Form S-1/A) 3 (July 15, 2013) ("We currently expect the initial public offering price to be between $21.00 and $23.00 per share of our common stock."), with WCI Communities, Inc., Registration Statement under Securities Act of 1933 (Form S-1/A) 3 (July 24, 2013) ("We currently expect the initial public offering price to be between $15.00 and $17.00 per share of our common stock.").
a reduced number of financial statements: while 32.3% of moderate-size offerings do so, only 24.0% of larger offerings, and none of the largest ones, do.

Perhaps most intriguingly, fully 35% of the EGCs used no accommodation that I could track; they disclosed three or more years of financials and did not file a draft registration statement. It may be that they are making use of other JOBS Act accommodations, such as the ability to test the waters or the ability to have pre-IPO analyst coverage, but that information is unavailable. There, are of course, other benefits to being an EGC after going public, such as a reprieve from some reporting obligations. These attractions could also explain the incidence of EGCs that make use of no accommodations at all.

Table 3 focuses on the effect of various accommodations on the gross spread, and thus also represents only emerging growth companies. If the accommodations are effective, the hypothesis is that the more accommodations an issuer seeks in the IPO, the safer, cheaper, and easier the underwriting proposition becomes, and accordingly the lower the spread will be. The data bear out this prediction with respect to draft registration statements, but not financial statements.

For moderate-size IPOs, issuers that make use of a confidential draft registration statement exhibit less clustering at the 7% level. All of the moderate-size EGCs that do not file a draft registration statement have spreads of 7%, compared with 92.1% of those that do file a draft statement. For larger IPOs this trend is more marked: while 91% of the large EGC IPOs that do not make use of the draft registration statement accommodation have a gross spread of 7%, only 64.3% of those firms that do file a draft registration statement hew to the 7% gross spread. Overall, 95% of firms that do not file a draft registration statement have a gross spread of exactly 7%, as compared to only 80% of those that make use of the accommodation. Thus the presence of a draft registration statement seems to make it more likely that the gross spread will be below 7%, albeit not much more likely.

Table 3 tells a different story when it comes to the financial statements accommodation. Taking first the moderate-size EGCs, those that disclose only two years of financials show less clustering than those with three years of financials, but not much less: 90.5% versus 97.7%. In contrast, larger IPOs making use of the financial statement accommodation results in more clustering than not doing so: 100% of large EGC issuers disclosing two years of financials exhibit a 7% spread, whereas only 68.4% of large EGC issuers disclosing three years of financials do so. Admittedly, the numbers in this category are small, making it hard to conclude much from the data. Overall, 92.6% of issuers making use of the financials accommodation cluster at 7%, whereas only 83.6% of issuers that do not make use of it cluster at that level.

Finally, I compare issuers who make full use of the accommodations—that is, issuers that file a confidential draft registration statement and disclose only

102 See supra note 18.
two years of financials, to issuers who make use of no accommodation. With respect to moderate IPOs, issuers that make full use of the accommodations exhibit less clustering than those that do not—88.2% compared with 100%, respectively. However, with larger IPOs the situation is reversed; issuers that make full use of the accommodations exhibit more clustering at 7% than those that do not. Indeed, 100% of large IPOs where the issuer uses both accommodations come in at exactly 7%, whereas 88.9% of those issuers with no accommodations clustered at 7%. However, this sample size is extremely small.

Table 4 presents the results from logistic regressions in which the dependent variable is equal to 1 if the spread is 7%, and 0 if it is below 7%. Each of the first three models examine a particular independent variable and the last column reports the result of combining all of the independent variables into one model. Model 1 analyzes the effect of IPO proceeds on the underwriter discount and finds, as expected and as other studies have shown, a significant and negative relationship between the size of the offering and the discount rate. In general, the larger the proceeds raised, the lower the spread is likely to be.

Model 2 examines the effect of the use of a draft registration statement on the discount rate. The variable DRS is equal to one if the firm uses a draft registration statement and is zero otherwise. The coefficient on this variable is negative and significant at the 10% level. This result is consistent with the hypothesis that the use of a draft registration statement accommodation reduces the risk the underwriter faces, thus reducing the spread below 7%.

Model 3 examines the effect of the disclosure of two rather than three years of financial data. The independent variable is equal to one if the firm files less than three years of financials in the registration. While the hypothesis predicted that the ability to disclose fewer financials would reduce the risk of liability to the underwriter, and thus lessen the cost of underwriting, the results provide no evidence consistent with this hypothesis. The number of years of financials disclosed has no effect on the spread.

Model 4 combines all of the variables in the previous models. This model not only retains the sign and significance of the coefficients on both the amount of IPO proceeds and the presence of a draft registration statement on the underwriting spread, but both the significance and magnitude of the coefficient on DRS increase. Thus, after controlling for size, the negative relationship between DRS and the spread increases in size and significance.
In conclusion, at least one provision of the JOBS Act seems to have been effective at reducing underwriter costs and, accordingly, underwriter fees. The ability to file a draft registration statement appears to make the underwriting task easier or less risky—and therefore cheaper. The ability to disclose only two years of financials had no such effect. Furthermore, while flexibility in underwriting pricing casts some doubt on the collusion story, it may be that spreads will coalesce around another (perhaps lower) point as the post-JOBS Act underwriting market establishes a new equilibrium. This Article's sample encompasses only the first sixteen months following the Act's passage. Subsequent research will cast further light on the long-term effect of the JOBS Act on underwriting spreads and on the process of going public.

Table 1—Gross Spread of EGC and Non-EGCs, 4/10/12 – 7/24/13

<table>
<thead>
<tr>
<th></th>
<th>Panel A: $29 to $109.99 million proceeds</th>
<th>Panel B: $110 to $277 million proceeds</th>
<th>Panel C: All IPOs (including &gt; $277 million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Spread</td>
<td>Below 7% 7% Above 7% All</td>
<td>Below 7% 7% Above 7% All</td>
<td>Below 7% 7% Mean: Gross Spread All</td>
</tr>
<tr>
<td>EGCs</td>
<td>4.6% (3) Mean: 6.7</td>
<td>95.4% (62) 0% 94.2% (65)</td>
<td>13.8% (33) Mean: 6.26</td>
</tr>
<tr>
<td>Non-EGCs</td>
<td>25% (1) Mean: 6.5</td>
<td>75% (3) 0% 5.5% (4)</td>
<td>86.7% (26) Mean: 5.39</td>
</tr>
<tr>
<td>All</td>
<td>5.8% (4) Mean: 6.65</td>
<td>94.2% (65) 0% 100% (69)</td>
<td>31.5% (39) Mean: 5.67</td>
</tr>
</tbody>
</table>
Table 2—Incidence of Accommodation, 4/10/12–7/24/13

<table>
<thead>
<tr>
<th>Panel</th>
<th>DRS</th>
<th>No DRS</th>
<th></th>
<th></th>
<th></th>
<th>Panel D: All EGC IPOs</th>
</tr>
</thead>
<tbody>
<tr>
<td>$29 to $109.99 million</td>
<td>58.5% (38)</td>
<td>41.5% (27)</td>
<td></td>
<td></td>
<td></td>
<td>58.5% (55)</td>
</tr>
<tr>
<td>proceeds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$110 to $277 million</td>
<td>56.0% (14)</td>
<td>44.0% (11)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>proceeds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&gt;$277 million</td>
<td>75.0% (3)</td>
<td>25.0% (1)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>proceeds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>All EGC IPOs</td>
<td>58.5% (55)</td>
<td>41.5% (39)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Years Financials</td>
<td>32.3% (21)</td>
<td>24.0% (6)</td>
<td>0%</td>
<td>0%</td>
<td>28.7% (27)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3+ Years Financials</td>
<td>67.7% (44)</td>
<td>76.0% (19)</td>
<td>100%</td>
<td>100%</td>
<td>71.3% (67)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>DRS + 2 Years Financials</td>
<td>26.2% (17)</td>
<td>16.5% (4)</td>
<td>0%</td>
<td>0%</td>
<td>22.3% (21)</td>
<td></td>
</tr>
<tr>
<td>(full accommodation)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No accommodation</td>
<td>35.4% (23)</td>
<td>36.0% (9)</td>
<td>25%</td>
<td>25%</td>
<td>35.1% (33)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Number of EGCs</td>
<td>65</td>
<td>25</td>
<td>4</td>
<td>94</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 3—Gross Spread of EGCs by Accommodation, 4/10/12–7/24/13

<table>
<thead>
<tr>
<th>Panel A: $29 to $109.99 million proceeds</th>
<th>Panel B: $110 to $277 million proceeds</th>
<th>Panel C: All EGC IPOs (Including &gt;$277 Million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Spread</td>
<td>Gross Spread</td>
<td>Gross Spread</td>
</tr>
<tr>
<td>Below 7%</td>
<td>Above 7%</td>
<td>Mean</td>
</tr>
<tr>
<td>-----</td>
<td>-----</td>
<td>-------</td>
</tr>
<tr>
<td>DRS</td>
<td>7.9% (3)</td>
<td>92.1% (35)</td>
</tr>
<tr>
<td>No DRS</td>
<td>0</td>
<td>100.0% (27)</td>
</tr>
<tr>
<td>2 Years Financials</td>
<td>9.5% (2)</td>
<td>90.5% (19)</td>
</tr>
<tr>
<td>3+ Years Financials</td>
<td>2.3% (1)</td>
<td>97.7% (43)</td>
</tr>
<tr>
<td>DRS + 2 Years Financials (full accommodation)</td>
<td>11.8% (2)</td>
<td>88.2% (15)</td>
</tr>
<tr>
<td>No Accommodation</td>
<td>0</td>
<td>100% (23)</td>
</tr>
</tbody>
</table>
Table 4—Effect of Accommodation on Gross Spread

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-0.020***</td>
<td>-</td>
<td>-</td>
<td>-0.022***</td>
</tr>
<tr>
<td></td>
<td>(.000)</td>
<td>(.000)</td>
<td>(.000)</td>
<td>(.000)</td>
</tr>
<tr>
<td>Proceeds</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>DRS</td>
<td>-</td>
<td>-1.531*</td>
<td>-</td>
<td>-1.862**</td>
</tr>
<tr>
<td></td>
<td>(0.057)</td>
<td>(0.036)</td>
<td>(0.092)</td>
<td>(0.118)</td>
</tr>
<tr>
<td>Less than 3 Years of Financials</td>
<td>-</td>
<td>0.898</td>
<td>-</td>
<td>0.118</td>
</tr>
<tr>
<td></td>
<td>(0.267)</td>
<td>(0.912)</td>
<td>(0.912)</td>
<td>(0.912)</td>
</tr>
<tr>
<td>Constant</td>
<td>4.818***</td>
<td>2.918***</td>
<td>1.627***</td>
<td>6.398***</td>
</tr>
<tr>
<td></td>
<td>(.000)</td>
<td>(.000)</td>
<td>(.000)</td>
<td>(.000)</td>
</tr>
<tr>
<td>N</td>
<td>94</td>
<td>94</td>
<td>94</td>
<td>94</td>
</tr>
<tr>
<td>Chi2</td>
<td>13.21***</td>
<td>3.62*</td>
<td>1.23</td>
<td>15.10***</td>
</tr>
<tr>
<td>Pseudo R2</td>
<td>.379</td>
<td>.063</td>
<td>.019</td>
<td>.433</td>
</tr>
</tbody>
</table>

* Significant at the 10 % level.
** Significant at the 5 % level.
*** Significant at the 1 % level.