Breaking the IPO market open again for emerging companies: The JOBS Act

A comparison with the Hong Kong market and the Eurozone

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Introduction

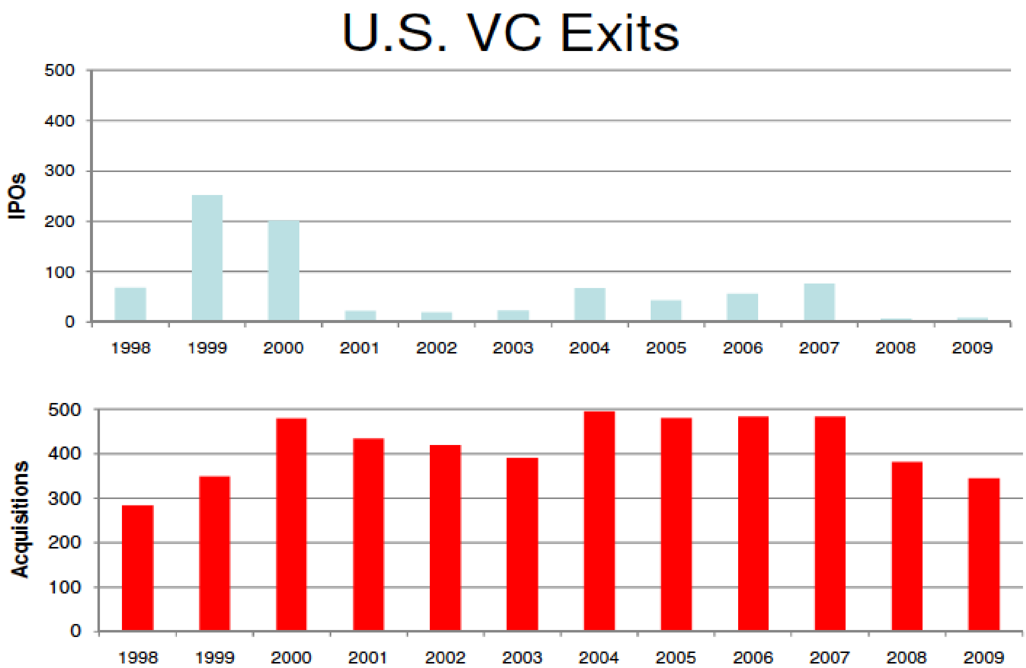
For the past ten years, mergers and acquisitions (hereafter: M&A) have outperformed initial public offerings (IPOs) as the most preferable exit strategy in the US. However, at the beginning of 2011 it seemed like the IPO was on its way back to become the most preferable exit strategy again. Since the potential for exit through an IPO is considered to be critical to a sound venture capital market (even if the exit often occurs through a trade sale[1]) and this, in turn, is an essential condition for the flourishing of innovative, job-creating small and medium enterprises (SMEs), efforts have been made to ease the path to an IPO. The Jumpstart Our Business Startups Act (JOBS Act) has been signed on April 5, 2012 by the President of the United States. The objective is to ease the IPO path for emerging companies. The bill reduces regulations and provides exemptions for such companies so that they can access the public capital markets more easily, which will increase American job creation and economic growth. In this thesis, it is investigated if this new piece of legislation could help breaking the IPO market open again for emerging companies. Therefore, we will also look at foreign markets since there are regulation-lite markets which actually have similar objectives: facilitating smaller companies by applying less strict regulations on them. Especially the Hong Kong IPO market is interesting. In 2011, it was the largest IPO market for the third successive year. Also an increasing number of US firms is listing its shares there. Hong Kong has the Growth Enterprise Market (GEM) which has the London based AIM as an example. Is it these lighter regulations applied on them that make small companies want to list there or are there other important factors? With Hong Kong being an important financial center and a gateway to Mainland China, it has a key position in the region. What exactly makes Hong Kong such an attractive place for listing? Also an analysis of the situation in Europe will be made. The Eurozone is suffering from a sovereign debt crisis and the confidence in European countries and companies has been decreased. Since jobs created by SMEs count for 85 % of all new jobs in the EU for the past 5 years[2], it is interesting to see what the EU is doing to facilitate emerging companies in attracting capital. Is Europe doing anything to create a strong IPO market and how are startups/SMEs facilitated? What will also be addressed are the recent developments in the venture capital industry. Venture-backed private companies are gradually becoming less interested in launching an IPO due to several reasons and capital is shifting from the public equity markets to the private equity markets such as SecondMarket. Does the JOBS Act still make sense then; could it still play a role when small companies are not that focused anymore on launching an IPO?

[1] R.J. Gilson and B.S. Black, 'Does Venture Capital Require an Active Stock Market?', *Journal of Applied Corporate Finance*, Winter 1999, pp. 36-48, p. 13
[2] According to a study carried out at the request of the EU Commission: 'The SME Performance Review'

In the first chapter, the current status of the US IPO market is discussed as well as the importance of an exit through IPO for the venture capital market. Also the downturn of the IPO market is addressed. In chapter 2, the JOBS Act will be discussed: its creation and the reasons behind it, the most important provisions and opinions on it. Not everyone is positive about this new legislation and concerns mainly arise in relation to crowdfunding and the possibility of abuse of the lighter regulations by scam artists. Chapter 3 investigates the Hong Kong IPO market from the current status as a very popular listing venue for both domestic as well as foreign companies to the reasons why it is so successful. The facilitation of IPOs will also be addressed; especially the GEM is of significant importance and therefore it will be compared to the Main Board in terms of listing requirements. The GEM has followed the example of the AIM by adopting a disclosure-based regime and fostering a self-compliance culture by the listed issuers and sponsors and despite of the depressed market, the GEM is doing well. The fourth chapter will be about the situation in Europe. The confidence in European countries and companies has decreased due to the foreign debt crisis. Is Europe doing anything to create a strong IPO market? The venture capital industry in Europe is very different from the US; this will also be discussed. In chapter 5, the recent changes in the venture capital cycle will be addressed. Due to the decline in IPOs, the 'traditional' VC cycle has been disrupted. Also the rise of private equity markets plays an important role in this. It is the question if IPO will ever be the golden standard for VC again because there are other alternatives and preferences; does the JOBS Act still make sense then?

Chapter 1 – Status quo of the US IPO market

There has been a downturn of IPOs in the US in recent years. The number of IPOs dropped from an average of 311 per year during 1980-2000 to 102 per year during 2000-2011.[3] Especially the number of small company IPOs has declined; from 165 IPOs per year in 1980-2000 to 30 IPOs per year in 2001-2009.[4] For the past ten years, M&A have outperformed IPOs as the most preferable exit strategy in the US, which is illustrated by the figure below. This is bad news for venture capitalists (VCs) since they depend on an active IPO market for their exit. There has to be an exit opportunity in the form of an IPO to make the venture capital cycle actually work, otherwise it becomes very difficult to attract investors. It also affects employment; the US has lost more than 10 million jobs because of lost IPOs since the 1990s.[5]



Source: Dow Jones Venture One in Wilmer Hale 2010 Venture Capital report

[3] J.R. Ritter, X. Gao and Z. Zhu, 'Where Have All the IPOs Gone?', *Working Paper Series*, March 13, 2012, p. 2
[4] Ibid
[5] Ibid

1.1 The Venture Capital cycle

To understand why an active IPO market is crucial for venture capitalists, it is needed to understand how the venture capital cycle works. The Venture Capital cycle typically starts with funds that are raising capital from institutional investors and private investors.[6] Such a fund is called a Venture Capital fund (VC fund) and it selects promising, innovative and often high technology startups to invest in. Being financed by a VC fund is beneficial for an entrepreneur since not only money is provided. A VC fund also provides the startup company with capital, management assistance, intensive monitoring of performance, reputational capital (which means that the startup is given credibility with third parties because of the appearance of the VC fund)[7] and a valuable network. VC funds typically have other portfolio companies in the same industry so the VC partners are experienced players and the startup company benefits from that experience in means of, for example, locating and recruiting management.[8] These non-capital inputs are valuable to early stage companies but as the company develops and gains experience, its need for those inputs of the VC fund declines.[9] At that moment, the VC fund also wants to exit; a liquidity event (most likely an IPO) occurs so that a significant part of the capital gains flow back to the investors and a new VC cycle can start. This already shows how important it is to have a good IPO market; it enables a sound VC market. When the company is able to do an IPO, the investors can exit to enjoy the gains of their investment and the entrepreneurs can reacquire control over the company. A sound VC market is, on its turn, one of the most important elements in order to create economic growth that is based on innovative and knowledge-intensive industries and the jobs that these small and medium enterprises create. Venture backed companies accounted for 12 million jobs and $ 3.1 trillion in revenue in the US in 2010, according to a 2011 Global Insight study.

In Silicon Valley, the Venture Capital cycle actually works. An important reason for this is the exit opportunity in the form of Nasdaq. It is stated that venture capital can flourish especially (and perhaps only) if the VC fund can exit the portfolio company through an IPO, which requires an active stock market.[10] So why exactly is the exit of the VC fund from its investments so important? We already saw that the need for the non-financial contributions of

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[6] J.M. Mendoza and E.P.M. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', *Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011*, May 3, 2011, p. 3
[7] R.J. Gilson and B.S. Black, 'Does Venture Capital Require an Active Stock Market?', *Journal of Applied Corporate Finance*, Winter 1999, pp. 36-48, p. 9
[8] Ibid
[9] Ibid
[10] Ibid, p. 1

the VC fund declines as the company grows. At the moment the company has become successful, it is time for the VC fund to exit so that it can recycle its financial contributions to other early stage companies[11] and the cycle starts all over again. Another reason why the exit is so important lies within the relationship between the VC fund and the investors in that fund.[12] There is an explicit contract between them (most likely a limited partnership agreement), which requires the liquidation of the partnership and the distribution of the proceeds amongst the limited partners after typically 7-10 years.[13] In addition, there is also an implicit contract, which implies that the limited partners will reinvest in future limited partnerships that are sponsored by successful VC funds.[14] This gives the VC fund a strong incentive to exit from their portfolio companies before the term of the partnership expires because then the limited partners are more likely to be convinced that investing in a new limited partnership with that venture capital fund is a good decision.

So it is clear why an exit is of utmost importance to the venture capital market, but why has this to be through an IPO? A venture capital firm has more options when it wants to exit its portfolio company, such as a trade sale, a buyback, the sale of shares to another investor, the reorganization of the company or a corporate liquidation.[15] The trade sale and the IPO are the two most preferable exit strategies in the US. However, the *potential* for exit through IPO is critical to a sound venture capital market, even if the exit often occurs through a trade sale.[16] The reason for this lies in the fact that the possibility for an exit through IPO allows the venture capitalist and the entrepreneur to enter into an implicit contract concerning future control of the company.[17] When the VC fund and the entrepreneur contract over the initial investment, the venture capitalist receives also significant control rights besides an equity interest. This is justified by the fact that they contribute a huge amount of money to a risky business; it is widely known that the failure rate amongst startups is high. However, when the company is successful, control will be returned to the entrepreneur when an exit through IPO occurs. This provides an incentive for the entrepreneur to use his best efforts to make the company a success and to refrain from opportunistic behavior since an IPO exit is only available if the company is successful. So actually, the entrepreneur has already received an implicit incentive contract denominated in control at the time of contracting over the initial

[11] Ibid, p. 11
[12] Ibid
[13] Ibid
[14] Ibid, p. 12
[15] J.A. McCahery and E.P.M. Vermeulen, *Corporate governance of non-listed companies*, Oxford University Press 2008, p. 164
[16] R.J. Gilson and B.S. Black, 'Does Venture Capital Require an Active Stock Market?', *Journal of Applied Corporate Finance*, Winter 1999, pp. 36-48, p. 13
[17] Ibid

investment.[18] With the possibility of an IPO in mind, the entrepreneur has something like a call option on control.[19] Therefore, it is important to have an IPO exit available; otherwise the entrepreneur does not have this incentive. When, for example, the venture capitalist exits through a trade sale, the acquirer receives control. This could never incentivize the entrepreneur as much as the opportunity to acquire control through an IPO exit.

1.2 Reasons for downturn IPO market

There could be several reasons why the IPO market has declined in recent years. M&A have outperformed IPO as most preferable exit strategy in the US for the past ten years, but how can this be explained? First, M&A are an easier option for VCs since IPOs impose a lock-up period, which M&A do not. However, Ritter, Gao and Zhu introduce *the economies of scope* hypothesis as an explanation.[20] This implies that, as part of a larger organization, earnings will be higher for a small firm because a larger organization can realize economies of scope and is able to bring new technology to the market faster. So the reason why many small firms prefer selling out in a trade sale is that a small firm is worth more as part of a larger organization[21] because of these economies of scope. Remaining independent then is a less attractive option. Trade sales can be considered as the 'easy' way of exiting but this does not mean that it always is the best way. However, there may also be synergy gains when an innovative startup is sold to a larger firm. Innovation may better flourish in a smaller firm and marketing or manufacturing may be better accomplished in a large firm.[22] Because of these synergy gains, a higher exit price can be realized through such a trade sale.

Another explanation could be the increased regulation following scandals like Enron in 2001. To prevent such scandals in the future by strengthening corporate governance and to bring back investors' confidence in companies, stricter regulation has been imposed on public companies. The Sarbanes-Oxley Act (SOX), enacted in July 2002, is the most significant piece of regulation and it caused additional compliance costs on publicly traded companies. SOX contains tightened disclosure rules, it requires the management of the firm to certify its periodic reports, it contains rules that aim at the strengthening of board independence and it raises auditor independence standards.[23] Complying with SOX is costly and especially for

[18] Ibid
[19] Ibid
[20] J.R. Ritter, X. Gao and Z. Zhu, 'Where Have All the IPOs Gone?', *Working Paper Series*, March 13, 2012, p. 3
[21] Ibid, p. 4
[22] R.J. Gilson and B.S. Black, 'Does Venture Capital Require an Active Stock Market?', *Journal of Applied Corporate Finance*, Winter 1999, pp. 36-48, p. 12
[23] E. Kamar, P. Karaca-Mandic and E.L. Talley, 'Sarbanes-Oxley's Effects on Small Firms: What is the Evidence?', *USC CLEO Research Paper No. C07-9; Harvard Law and Economics Discussion Paper No. 588; USC Law Legal Studies Paper No. 07-8,* June 2007, p. 1

small companies these costs are onerous since they have fewer resources and are not enjoying economies of scale as much as larger firms, yet they have to comply with the same regulation. Especially Section 404 of the SOX is regarded to be the most costly requirement. It requires that a public company includes management and auditor reports on the effectiveness of internal control in the annual report. A reason why small firms experience a large increase in audit fees compared to larger firms is that costs in relation with establishing, maintaining and evaluating internal controls over financial reporting are mostly fixed.[24] There is also evidence that, regardless of the company size, SOX increased the accounting and audit costs of public firms.[25] However, before SOX was enacted, these costs were already disproportionately high for small firms and after the enactment, this disparity increased even more; especially for small firms subject to Section 404.[26] Despite all the bad news for small companies, SOX could have some benefits for them. It might be easier to make the transition to publicly traded status since all the additional reports and assessments required by SOX might help attracting investors since they can show that good internal controls are already in place.[27] This makes a small business investment less risky than in the past. However, several studies have been conducted on the effect of SOX on firms and they consistently find a negative effect on small firms.[28] The SOX requirements do impose increased compliance costs on doing business as a public company and when the startup company grows larger, it has to choose whether the benefits of going public outweigh the costs associated with the regulatory requirements.[29] With these costs being high and the difficulties getting listed involves, the number of listings is decreasing. This is bad for entrepreneurship considering the importance of an exit opportunity for the venture capital market. If an exit such as Nasdaq is so important, it is bad that this exit is actually blocked. Easing the path to public markets might be a solution since the biggest problem of venture capitalists has been a shortfall in exit proceeds.

[24] Ibid, p. 9
[25] Ibid, p. 1
[26] Ibid, p. 12
[27] L. Dixon, S.M. Gates, K. Kapur, S.A. Seabury, E. Talley, 'The impact of regulation and litigation on small business and entrepreneurship', *RAND Working paper*, February 2006, p.17
[28] E. Kamar, P. Karaca-Mandic and E.L. Talley, 'Sarbanes-Oxley's Effects on Small Firms: What is the Evidence?', *USC CLEO Research Paper No. C07-9; Harvard Law and Economics Discussion Paper No. 588; USC Law Legal Studies Paper No. 07-8,* June 2007, p. 18
[29] L. Dixon, S.M. Gates, K. Kapur, S.A. Seabury, E. Talley, 'The impact of regulation and litigation on small business and entrepreneurship', *RAND Working paper*, February 2006, p.16

1.3 Rebound of the market for venture backed IPOs?

At the beginning of 2011, it seemed like IPO was on its way back to become the most preferable exit strategy again. In Q2 and Q4 of 2011, the US IPO market came back to its usual strength because several venture-backed private companies such as LinkedIn, Groupon, Zynga and Pandora launched their IPO. In Q4, eleven venture-backed companies went public, with Zynga doing the largest IPO of the quarter. At the end of 2011, the venture capital return numbers stabilized and it seems that 2011 was a year of recovery.[30]
However, the quality of several IPOs in 2011 was doubtful. Virtually all of these companies that launched an IPO in 2011 have experienced a drop in their share price below their initial offering prices. Groupon for example launched its IPO the 3th of November, pricing its stock at $ 20 per share. In the following 2 months, the price dropped several times below the initial public offering price. Zynga held its IPO in December 2011 and its shares closed at $ 9.50 short afterwards, which is a drop of 5 % below their IPO price. A disastrous example is Facebook's IPO, which will also be addressed later on. It was one of the most hyped IPOs in 2012 until now but by the end of its third day of trading, its stock was down more than 18 % of its initial offering price.

The drop in share price following the IPO is an indication that investors lost money on investing in these companies and that the market perceives these companies to be worth much less than their IPO valuations. This means that investors have realized that the value of these companies is much less than what was speculated before the IPO when they were still private. After their IPO, these companies are finally subject to the disclosure obligations under the '33 and '34 Act, which made the investors realize that the value is much less than speculated. So while there have been more IPOs, their quality was not that good given the fact that many companies experienced a drop in their share price following the IPO, which is a bad sign.

Based on the foregoing, one should not be deceived by the fact that the number of IPOs has risen again in the US in 2011. When taking a realistic look at the IPO market, it is clear that the number of listings is decreasing because, among possible other factors, it has become more costly and difficult to become and to stay a public company because of increased regulation. It is a good idea to ease the path to public markets since the venture community's biggest problem has been a shortfall in exit proceeds.

[30] Press release VC performance Q4 2011 on the NVCA website

Chapter 2 - The JOBS Act

The H.R.3606 bill, also known as the 'Reopening American Capital Markets to Emerging Growth Companies Act of 2011', was introduced on the 8th of December 2011. The sixth and final version of this bill, called the 'Jumpstart Our Business Startups Act' (or the 'JOBS Act'), was signed by the President of the United States on April 5, 2012. The Act contains amendments of various securities regulations, which are intended to help emerging growth companies by reducing the cost of going public; it should ease the path to an IPO. As said before, an IPO is very important for the venture capital market and such a market is, in turn, essential for innovative, job-creating small and medium enterprises. Access to capital through an IPO is of utmost importance for innovative companies to grow and to create jobs.

<u>2.1 The creation of the H.R.3606 bill</u>

Due to concerns on the declining IPO market and the situation of the US job market, the 'Access to Capital' Conference was held in March 2011 by the US Treasury Department to gather insights and recommendations on how to restore access to capital for emerging companies with a focus on public capital through the IPO market.[31] A group of professionals consisting of venture capitalists, experienced CEOs, securities lawyers, investment bankers, public investors and academicians decided thereupon to form the IPO Task Force to research the difficulties emerging growth companies face in pursuing an IPO and to come up with recommendations to restore access to public capital for such companies. On October 20, 2011, the IPO task force presented their recommendations to the US Department of the Treasury in their report "Rebuilding the IPO On-Ramp; Putting emerging growth companies and the job market back on the road to growth." One of the main things the IPO Task Force concluded is that the cumulative effect of a sequence of regulatory actions, rather than one single event, lies at the heart of the crisis.[32] Regulations that were adopted over the past decades were mostly intended to protect investors from the behavior of large corporations in response to scandals like Enron. They were meant to restore the confidence in public markets by placing more stringent rules on public companies. However, such regulations are often not suitable for small and medium enterprises since these regulations are 'one size fits all' by nature. It places a heavy burden on them when they have to comply with such regulations while they pursue an IPO to attract public capital. The average cost of achieving initial regulatory compliance for an IPO is $ 2.5 million and once public, the average cost of ongoing

[31] IPO Task Force, 'Rebuilding the IPO On-Ramp; Putting emerging companies and the job market back on the road to growth', October 20, 2011
[32] Ibid

compliance to stay public, is $ 1.5 million per year.[33] Due to this fact that an IPO is (too) costly for emerging growth companies, the number of companies that decided to go public went down. As opposed to those in emerging international markets, entrepreneurs in the US do not desire to grow their business into a large public company due to the costs, uncertainties and liabilities now involved with going public. They do not think the rewards are worth it and this is killing the capital formation cycle we have relied on for so long.[34] Furthermore, regulations caused constraints on the amount of information available to investors about emerging growth companies which makes them more difficult to understand and invest in.[35] Another problem lies in the shift from long term investing in such companies towards a short term, high-frequency trading driven by volatility of large-cap stocks which makes it for these companies less attractive and more difficult to do an IPO.[36] Investor protection remains of great importance, therefore the recommendations made by the IPO Task Force aim at bringing the existing regulations in line with current market realities[37] without harming investor protection. In short, the Task Force provided three recommendations to policy makers.

The first one is to provide an 'on ramp' for a new category of issuer (the emerging growth company) using existing principles of scaled regulation.[38] Companies will fall under this category when their annual revenue is less than $ 1 billion and following the IPO, they have less than $ 700 million in publicly traded shares.[39] This on-ramp is of transitional nature which means that following an IPO, these companies are given five instead of the usual two years to implement the requirements for a reporting company during which a modified regulatory framework applies to them. When those five years have elapsed, they have to fully comply with the same regulations as a usual listed company.[40] A Smaller Reporting Company (SRC) is an already existing category on which scaled regulation is applied but this does not cover the companies we are talking about now. It is stated in the report of the Task Force that such regulations are beneficial for companies with market capitalizations of less than $ 75 million, however, the companies we are talking about are high-growth, venture-backed companies that go public in order to finance their growth and they mostly raise between $ 50 and 150 million. They cannot make use of scaled regulation because they are not considered

[33] IPO Task Force, 'Rebuilding the IPO On-Ramp; Putting emerging companies and the job market back on the road to growth', October 20, 2011, Appendix C
[34] S. Cutler, Sr. Vice President Global Corporate Group, NYSE Euronext in the IPO Task Force report
[35] Ibid
[36] Ibid
[37] Ibid
[38] Ibid,p. 19
[39] IPO Task Force, 'Rebuilding the IPO On-Ramp; Putting emerging companies and the job market back on the road to growth', October 20, 2011
[40] A usual listed company that has 'public company' status, this threshold is set by Section 12(9)-1 of the '34 Act: when a company has a minimum of $ 10 million in total assets and 500 shareholders, it is a public company.

as SRCs and have to comply with the same regulations as very large companies, although they have much fewer resources. The 'on ramp' for emerging growth companies would fill in the regulatory gap between the SRC category and the regulations for large-scale firms.

The second recommendation made to policymakers involves a better availability and flow of information for investors before and after an IPO.[41] For example, existing regulation contains restrictions on communications during the IPO offering process. The reason behind this so called 'quiet period' imposed by the SEC lies within giving investors the possibility and time to do their due diligence without the market being disrupted by statements from, for example, the firm's management that tries to hype the stock.[42] While aiming at investor protection, these kinds of regulations are an inconvenience and considered to be outdated. Emerging growth companies, like other non-public companies, normally have no audience of public investors before their IPO.[43] This means that the quiet period does not make sense to them and it is only inconvenient to have to comply with regulations that are actually intended for companies that usually have shares that are already traded on the secondary market. According to the Task Force, restrictions on communications during the offering process are also outdated since they were created in an era where issuer and investor relations depended on paper-based communication.[44]

The third recommendation the IPO Task Force makes is to lower the capital gains tax rate for investors who purchase shares in an IPO and hold these shares for a minimum of two years.[45] When the capital gains tax rate is lowered, this will encourage and reward long-term investors. The demand for emerging growth stock will increase and from the perspective of the issuer, it is important to attract such long-term investors at the initial allocation since it determines how much capital the company raises through the IPO.[46]

On December 8, 2011 Congressman Stephen Fincher (republican, representing Tennessee) introduced the H.R.3606 bill. The bill builds upon substantive parts of the recommendations of the IPO Task Force. During the Committee process, he and the democrat John Carney, representing Delaware, supported it with a bipartisan approach. The reason for introducing

[41] IPO Task Force, 'Rebuilding the IPO On-Ramp; Putting emerging companies and the job market back on the road to growth', October 20, 2011
[42] D.J. Bradley, B.D. Jordan, J.R. Ritter and J.G. Wolf, 'The IPO quiet period revisited', *Journal of Investment Management* Vol. 2, No. 3 (2004), pp. 1-11
[43] S.J. Choi and A.C. Pritchard, *Securities regulation: Cases and analysis (Second Edition),* New York: Thomson/Foundation Press 2008, p. 461
[44] IPO Task Force, 'Rebuilding the IPO On-Ramp; Putting emerging companies and the job market back on the road to growth', October 20, 2011, p. 26
[45] Ibid, p. 30
[46] Ibid

this bill lies in the ability of small and medium enterprises to grow, innovate and thus hire new workers. This could help to contribute to a solution for the problems of unemployment in the US. For the last ten years, the number of companies launching an IPO has fallen dramatically and with this bill, they want to try to reverse this trend. Congressman Fincher says, in support of this bill, that small companies are the US' best job creators but that these companies have been the hardest hit by burdensome regulations. He also states that on average, 92 % of a company's job growth occurs after an IPO. Therefore, it is needed that regulations are being reduced to help these small companies create private jobs for Americans.[47] Also Congressman Carney states that making it easier for small companies to grow is the best way to create jobs and grow the economy. According to him, this legislation will encourage more entrepreneurs to start a business and it allows more start-ups to become public companies.[48]

The H.R.3606 bill was introduced and referred to the House Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises, which held hearings on the 15th of December 2011 and voted in favor of the bill as of the 16th of February 2012. There are five other bills related to the H.R.3606 bill and this legislative package, named 'Jumpstart Our Business Startups Act', was at the time of writing just signed by the President of the United States on April 5, 2012.

2.2 The JOBS Act

The JOBS Act (not to be confused with that other 'American Jobs Act' from 2011) is a legislative package consisting of six related bills or acts; H.R.3606 ('Reopening American capital markets to emerging growth companies Act'), H.R.2940 ('The access to capital for job creators Act'), H.R.2930 ('The entrepreneur access to capital Act'), H.R.1070 ('The small company capital formation Act'), H.R.2167 ('The private company flexibility and growth Act') and H.R.4088 ('The capital expansion Act'). This legislative package contains amendments to, for example, the Sarbanes-Oxley Act, the Securities Act of 1933 and the Securities Exchange Act of 1934. While it is a whole different piece of legislation than the American Jobs Act, the name has been chosen for a reason; the purpose is to create jobs through jumpstarting US business startups.

[47] Press release on: http://fincher.house.gov/press-release/reps-fincher-and-carney-introduce-bipartisan-legislation-help-small-companies-grow
[48] Ibid

2.2.1 Title I: Reopening American capital markets to emerging growth companies

The H.R.3606 bill (implemented as 'Title I' in the JOBS Act), which has been discussed earlier, builds upon substantive parts of the recommendations of the IPO Task Force. To begin with, it amends the '33 and '34 Act by adding the definition of an 'emerging growth company' to it.[49] This is a crucial concept since the reliefs in this bill apply to this category of companies. In Section 101, a definition is given. In short, an 'emerging growth company' is a new type of issuer that has an annual revenue of less than $1 billion and following the IPO, less than $700 million in publicly traded shares (otherwise it becomes a 'large accelerated filer' as defined in Section 240.12b-2 of Title 17 of the Code of Federal Regulations). Many of the small and medium enterprises, such as start-up firms, will fall under this definition and thus can make use of the exemptions that the bill introduces for them. It is this category of companies that faces expensive hurdles in the means of complying with a variety of regulations when accessing public capital. This category is now provided with a temporary reprieve from the SEC regulations. These exemptions will end after five years from the date of the IPO or when the company reaches $1 billion in revenue or when it becomes a 'large accelerated filer', which means that it has $700 million in publicly traded shares. In this way, an 'on-ramp' situation is created for small companies. During this period of time, they are subject to less strict regulation in terms of disclosure for example, which creates the opportunity to access capital and to grow. This will also lead to more job creation within the company. The regulatory reliefs in this bill are meant to be transitional; it encourages small companies to go public but the purpose is that, as they grow large enough to build up resources, in the end they fully conform to the applicable regulations.[50]

In Section 103, one of the most important exemptions for emerging growth companies is given. They are not required anymore to comply with Section 404(b) of the Sarbanes-Oxley Act (SOX 404). SOX 404 is about the assessment of internal control; it requires the management to present a report on the effectiveness of the firm's internal control. This internal control report forms a part of the Annual Exchange report of the company. Complying with SOX 404 is very costly; one research found for example that the mean total compliance costs for SOX 404 is $ 2.2 million.[51] Auditing Standard No. 2, which has been issued by the PCAOB, further requires the auditor to give his opinion on the internal control

[49] Section 101, Title I JOBS Act
[50] *Legislative Package Combines Financial Services Committee Bills into JOBS Act,* Press release on The Committee on Financial Services' website, February 28, 2012
[51] J. Krishnan, D.V. Rama and Y. Zhang, 'Costs to Comply with SOX Section 404', *Auditing: A Journal of Practice & Theory*, Vol. 27, No. 1, May 2008, pp. 169-186, p. 2

of the client and also on the management's assessment of such controls.[52] This results in three categories of complying costs: internal labor costs related to, for example, the hiring of new staff to expand the internal audit department, external consulting (when internal control work is outsourced) and technology expenses to upgrade computer systems or to purchase special software designed for SOX 404 and additional audit fees that arise due to Auditing Standard No. 2.[53] It is especially for small companies very burdensome to comply with SOX 404; when considering the mean total costs of $ 2.2 million, one can easily understand that this is a disproportionate cost for such companies. Thus, Section 103 of the JOBS Act is a great relief for emerging growth companies since they are not required anymore to have an auditor giving his opinion on the internal control and on the management's assessment of such controls. Investor protection is ensured because emerging growth companies are still required to provide audited financial statements and to establish and maintain internal controls over financial reporting.

Section 102 of the JOBS Act amends the '33 and '34 Act in terms of less strict disclosure obligations in the field of executive compensation and financial disclosures for emerging growth companies. For example, Section 14A on shareholder approval of executive compensation is amended by exempting emerging growth companies from the requirements in subsections (a) and (b). This means that a separate resolution subject to shareholder vote to approve the compensation of executives or approval of a golden parachute is not required for them. Especially for smaller companies, this is a great relief since such requirements are actually intended for large-scale companies. In many innovating emerging growth companies, such shareholder approvals are not desirable since the ownership in these companies is not as dispersed as in a large company that has its shares publicly traded for a long time already. Furthermore, Section 14(i) of the '34 Act is amended by exempting emerging growth companies from the requirement to disclose in any proxy or consent solicitation information that shows the relationship between executive compensation actually paid and the financial performance of the issuer.[54] An example of how the financial disclosure obligations are loosened can be found in Section 102 (b) which inserts a clause on the treatment of emerging growth companies into Section 7(a) of the '33 Act; emerging growth companies are required only two years of audited financial statements in their registration statement.[55]

Another significant amendment can be found in Section 105 of the JOBS Act, which increases the availability of information about emerging growth companies by amending

[52] Ibid, p. 1
[53] Ibid
[54] Section 102(a)(2) JOBS Act
[55] Section 102(b)(1) JOBS Act

Section 2(a)(3) of the '33 Act. This means that brokers and dealers, even if they are underwriters participating in the company's IPO, are allowed to publish or distribute a research report about the company prior to or following the IPO.[56] Such a research report shall then be deemed not to constitute an offer for sale or offer to sell a security. This is important because securities laws have given a broad definition to the term 'offer'; according to the SEC, it encompasses all communications that may 'condition' the market for securities.[57] A research report as described above is likely to fall within this definition since findings in such a report may have effects on the market for securities in terms of a higher demand and thus a higher price for example. Section 5(a) of the '33 Act does not allow sales until the registration statement becomes effective and Section 5(c) bans all offers prior to the filing of the registration statement so it is necessary that such research reports shall be deemed not to constitute an offer in order to avoid violation of Section 5(a) or 5(c) of the '33 Act. In this way, it is safe for brokers and dealers to publish or distribute a research report about the company prior to or following the IPO and this will lead to an increased flow of information to potential investors.

Section 107 of the JOBS Act provides an opt-in right for emerging growth companies. They are not obliged to make use of the exemptions designated for them; they can also choose to comply with the requirements that apply to a 'normal' issuer. However, they have to make such choice at the time they are first required to file a registration statement, periodic report or other report with the Commission under Section 13 of the '34 Act and the SEC has to be notified.[58] Furthermore, companies are not allowed to select some standards that apply to a 'normal' issuer to comply with; if they choose to be treated as a normal issuer they have to comply with all the standards such an issuer has to comply with.

2.2.2 Title II: Access to capital for job creators

H.R.2940 (implemented as Title II in the JOBS Act) makes it possible for Regulation D issuers to advertise or to use solicitation to reach investors and thus obtain capital. Regulation D issuers are small companies who are exempted from certain requirements; they do not have to register their securities with the SEC. A Regulation D offering makes it possible for small companies to access the capital market without having to bear the costs of a normal SEC

[56] Section 105(a) JOBS Act
[57] S.J. Choi and A.C. Pritchard, *Securities regulation: Cases and analysis (Second Edition),* New York: Thomson/Foundation Press 2008, p. 436
[58] Section 107(b) JOBS Act

registration. However, Rule 502(c) of the '33 Act bans general solicitations.[59] This makes it hard for small companies to raise capital since the pool of potential investors is limited. When Regulation D issuers are allowed to advertise or to use solicitation, they are able to reach a larger pool of investors. The purchasers have to be 'accredited investors' so that less sophisticated investors like retail investors are not put at a risk.

2.2.3 Title III: Crowdfunding

H.R.2930 (previously named 'The entrepreneur access to capital Act' and now implemented as Title III in the JOBS Act) makes it possible for entrepreneurs to make use of 'crowdfunding' by removing the SEC restrictions that prevented this before. Section 5 of the '33 Act prohibits the sale of any security unless it is accompanied by a prospectus that meets the requirements of subsection (a) of Section 10 of the Act. Section 4 contains exempted transactions to which Section 5 does not apply. Title III of the JOBS Act amends Section 4 of the '33 Act by adding the crowdfunding exemption at the end and by adding Section 4A (named 'Requirements with respect to certain small transactions') to it which contains requirements to qualify for the crowdfunding exemption. In short, Section 4A contains requirements on intermediaries and for issuers and if they meet these requirements, financing via crowdfunding is allowed. The Senate made an amendment to the crowdfunding exemption by requiring intermediaries in such an offering to be registered with the SEC.[60] Crowdfunding can generally be described as involving '*an open call, mostly through the Internet, for the provision of financial resources either in form of donation or in exchange for the future product or some form of reward and/or voting rights.*'[61] By making crowdfunding a legal option for startups, entrepreneurs will be able to raise equity capital from a large pool of small investors.[62] Another advantage for entrepreneurs is that the investors will not really get involved compared to, for example, venture capitalists. Financing through venture capital and angel investors can also be a slow process while crowdfunding could be more efficient for entrepreneurs.

The crowdfunding exemption allows startups to pool up to $ 1 million during a 12-month period without having to make a public offering.[63] It also sets limitations on individual contributions: when an investor's net worth or annual income is less than $ 100.000, he is

[59] S.J. Choi and A.C. Pritchard, *Securities regulation: Cases and analysis (Second Edition)*, New York: Thomson/Foundation Press 2008, p. 584
[60] Congressional Record, 112th Congress, 2nd session, March 19, 2012
[61] Definition derived from: P. Belleflamme, T. Lambert and A. Schwienbacher, 'Crowdfunding: Tapping the Right Crowd', *CORE Discussion Paper No. 2011/32,* April 25, 2012
[62] http://majorityleader.gov/uploadedfiles/JOBSACTOnePager.pdf
[63] Section 302 JOBS Act

only allowed to contribute $ 2000 or 5% of his annual income or net worth, whichever is less. For investors with a higher net worth or annual income than $ 100.000 the limitation is set at 10%, not exceeding a maximum aggregate amount of $ 100.000.[64] In this way, it is ensured that there are many retail investors and they will not encounter too much trouble in the unfortunate event in which they will loose their money.

2.2.4 Title IV: Small company capital formation Act

Title IV of the JOBS Act (the small company capital formation Act or H.R.1070) amends Regulation A. Regulation A is a Section 3(b) exemption and Section 401 of the JOBS Act amends Section 3(b) of the '33 Act by inserting a new exemption from registration under the '33 Act. A Regulation A offering is an attractive option for small issuers to raise capital because securities sold through Regulation A enjoy unrestricted status which means that secondary market trading is allowed to commence immediately after the shares are sold to the public.[65] This is an advantage when you compare it to, for example, a Regulation D offering because those shares suffer from an illiquidity discount.[66] However, a disadvantage was that the offering threshold for a Regulation A offering was set at $ 5 million. Section 401 of the JOBS Act increases this threshold to $ 50 million; companies are allowed to offer up to $ 50 million of their securities during a period of 12 months. The securities issued under this new exemption may be sold publicly and they are not considered to be restricted securities. Section 402 of the JOBS Act demands a study on the impact of 'Blue Sky Laws' (State laws that regulate the offering and sale of securities focusing on fraud prevention) on offerings made under Regulation A and to report the findings to the Committee on Financial Services of the House of Representatives, and the Committee on Banking, Housing, and Urban Affairs of the Senate not later than 3 months after the date of enactment of the JOBS Act. This new exemption is issuer friendly since one is able to raise up to $ 50 million in unrestricted securities while the disclosure obligations are limited; an offering statement, an offering circular and financial statements which do not necessarily have to be audited. These disclosure obligations are less expensive and not as cumbersome compared to a traditional IPO. Investors are still protected since the civil liability provision in Section 12(a)(2) still applies[67] and the issuer is required to file audited financial statements with the SEC annually.[68]

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[64] Ibid
[65] S.J. Choi and A.C. Pritchard, *Securities regulation: Cases and analysis (Second Edition)*, New York: Thomson/Foundation Press 2008, p. 602
[66] Ibid
[67] Section 401(b)(2)(D) JOBS Act
[68] Section 401(b)(2)(F) JOBS Act

2.2.5 Title V: Private company flexibility and growth Act

The private company flexibility and growth Act (formerly titled as H.R.2167 and now implemented as Title V in the JOBS Act) raises the shareholder registration requirement threshold from 500 to 2000 shareholders.[69] Currently, under Section 12(g) of the '34 Act, a company becomes an 'Exchange Act reporting company' when it has over 500 shareholders and more than $ 10 million in assets. This shareholder limit is especially a problem for growing companies in the high-tech sector (for example those in Silicon Valley) since they are dependent on option-based compensation to attract employees and they often do private offerings in private secondary markets, which can also cause that they reach the shareholder limit quickly. When the number of shareholders becomes too large (e.g., over 499) the company is forced to 'go public' when they in fact may not be ready at all to do an IPO.[70] An example of a company that bumped up against the 500 shareholders limit is Facebook. It was rapidly growing as a private company so compensating their employees in stock became more difficult because then they would reach the 500 shareholders limit too quickly. At the time of writing, the world was waiting for the most hyped IPO of the year; Facebook was going public May, 18 on NASDAQ. It priced its shares at $ 38 each and it was valued at $ 104 bn, which ranks them into the top 25 of most valuable public companies in the US. Facebook's IPO was planning to raise $16 bn, therefore it is the third largest IPO in US history and the largest tech IPO in history.[71] Opinions on what will happen differed; some experts believed that Facebook trading would be likely to be volatile over the next few weeks and months and some even predict that its strong initial pricing will tamp down any first day 'pop'.[72] Others predict a jump varying from 5 to even 20 %.[73] By now, we know what happened: already by the end of its third day of trading, its stock was down more than 18 % of its initial offering price. It was the most hyped IPO of 2012 until now but it turned into a disaster. However, Facebook is an interesting example because earlier in its lifespan it bumped up against the registration requirement of 500 shareholders.[74] Title V of the JOBS Act raises this threshold to 2000 shareholders and, more importantly for growing companies who are dependent on stock options to attract employees or have their shares traded in the private secondary market; it exempts employees and accredited investors from the count. In this way, small companies are given the time they need to develop.

[69] Section 501 JOBS Act
[70] S.J. Choi and A.C. Pritchard, *Securities regulation: Cases and analysis (Second Edition)*, New York: Thomson/Foundation Press 2008, p. 152-153
[71] J. Pepitone, 'Facebook's IPO price: $ 38 per share' in *CNN Money*, May 17, 2012
[72] T. Demos, 'FB trading likely to be volatile' in *The Financial Times*, May 18, 2012
[73] Ibid
[74] S. McGee, 'JOBS bill opens doors to growth..and scam artists' in *The Fiscal Times*, March 12, 2012

2.2.6 Title VI: Capital expansion Act

The capital expansion Act (H.R.4088 and now implemented as Title VI in the JOBS Act) makes it possible for community banks to have more than 500 shareholders; the threshold will be increased to 2000 shareholders. Because of this, community banks can better deploy their capital to make loans and create jobs instead of having to comply with burdensome SEC regulations.[75] As a result, raising equity capital from new shareholders will be facilitated for these small financial institutions without triggering the SEC oversight.[76]

2.3 Opinions on the JOBS Act

As with every new piece of legislation, the opinions on the content and the effect the bill will generate differ. Not everyone is that positive about the JOBS Act. For example some Democrats, such as Harry Reid (Democratic Senate majority leader) and securities law experts such as the former chief accountant for the SEC; Lynn Turner, think that the impact of the JOBS Act on job creation will be somewhat limited. They fear that investors will be harmed by the loosening of rules and this will make them less likely to invest in smaller companies.[77] Those rules are there for a reason; after scandals like Enron, it was needed to rebuild investors' confidence in companies. Some people ask themselves if House members have forgotten the lessons of Enron and other financial scandals. When the rules are loosened, fraud is more likely to occur. The hurdles for accessing the market are lowered which leads, in turn, to the downturn of the credit and investment quality of the people and companies raising money. This is an iron rule in financial markets and it could lead to subprime IPOs.[78] However, such subprime IPOs already took place without the JOBS Act. In 2011, there already were IPOs on which investors lost money because the share price dropped following the IPO, which indicates that the market perceives these companies to be worth much less than their IPO valuations. But the JOBS Act could make it in fact easier for weaker companies to enter the capital markets while at the same time it enables the best private companies to stay private longer. This will not really encourage investors.

Also crowdfunding led to discussion; it makes it possible for 'ordinary' investors to invest in startups through the Internet and social media. The danger lies in the fact that the ordinary public does not consist of accredited investors and the companies using crowdfunding are not

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[75] http://majorityleader.gov/uploadedfiles/JOBSACTOnePager.pdf
[76] *Legislative Package Combines Financial Services Committee Bills into JOBS Act,* Press release on The Committee on Financial Services' website, February 28, 2012
[77] Ibid
[78] R. Waters, 'Effects of the Jobs Act are hard to predict' in *The Financial Times*, April 4, 2012

required to provide substantial disclosure. Some people believe this gives an opportunity for 'scam artists'. There is also reason to predict crowdfunding would not result in such successful businesses as those financed by venture capitalists because they not only provide money but also very useful knowledge, advise and a valuable network. A startup company enjoys great benefits of the venture capitalists because these experienced people are really involved in the business and bring along their knowledge. Financing through crowdfunding is different; a lot of small investors only contribute money, nothing else. However, this last argument does not seem legit since the objective of crowdfunding is not to substitute VC but to complement it in the very early stages of the VC cycle.

There can also be doubts concerning Section 5 of the JOBS Act, which make it possible for brokers/dealers to publish or distribute a research report about companies prior to or following the IPO. This should lead to an increased flow of information to potential investors. However, in private secondary markets such as SharesPost this already happens; several research reports were released on Facebook. This caused a growing appetite for its stock while it was already traded in the private market. It seems that the IPO valuation was based on the trading price in the private market[79]. By now, we know that it was overvalued since the share price dropped dramatically after the IPO. Therefore, does the increased flow of information in the form of research reports indeed lead to better outcomes? At least this cannot be said in the case of Facebook.

Others argue that there is a fundamental problem that the JOBS Act cannot tackle: the number of companies that were profitable after their IPO has fallen sharply in the past decade and especially small company IPOs have faced declining profitability. The returns for public market investors were consistently low and it became more likely that those companies would be involved in acquisitions.[80] Of course investors are not very eager to invest in companies that will lose money and the JOBS Act does not change this.[81]

Supporters of the JOBS Act say that it will help small and medium sized enterprises to raise capital. The small number of IPOs in the US is the reason why this legislation is needed.[82] By having access to the capital markets, small and medium enterprises will be able to expand, develop and hire new employees. Thus, as a final result, it will create jobs and contribute to the economy as a whole because it stimulates the development of innovative, high-growth

[79] T. Kosdrosky, 'Facebook's IPO flop' in Q&A with Professor Amiyatosh Purnanandam of Michigan Ross School of Business: http://www.bus.umich.edu/NewsRoom/ArticleDisplay.asp?news_id=24081
[80] J.R. Ritter, X. Gao and Z. Zhu, 'Where Have All the IPOs Gone?', *Working paper series*, March 13, 2012, p. 1
[81] S. Nasiripour and T. Demos, 'Jobs act draws scepticism' in *The Financial Times*, April 4, 2012
[82] Ibid

companies. Furthermore, the strict regulations and requirements of the SEC in the field of disclosure for example are designed for large-scale companies that already have their shares publicly traded for a while. Such regulation is not suitable for small startups planning to do their IPO since they mostly don not have the particular structure a large-scale corporation has so it is a good thing to provide certain exemptions for them. In this way, they can deploy their money to growth and to prepare for their IPO. Especially at a time where credit is scarce it is important to facilitate raising equity capital for smaller companies.

An important argument in favor of the JOBS Act is that is does not dismantle existing regulation.[83] Opponents often come up with this argument of harming investor protection. However, the potential costs of bad behavior will be mitigated by the benefits of having more new companies established and able to go public.[84] Moreover, fraud in newly public companies is not a problem; history has shown that. The reason for this is the intense evaluation and examination process by lawyers, the SEC, accountants, underwriters and investors.[85]

It is hard to predict the effects of the JOBS Act and time will tell us what the exact impact on the economy and especially job creation will be. However, it might be useful to take a look at foreign IPO markets to see if there is similar regulation or important differences and what effects these have on the IPO markets and economic growth. Therefore, we will compare the US IPO market with the Hong Kong IPO market in the next chapter.

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[83] W. Sahlman, 'How the NY Times got the JOBS Act wrong', March 15, 2012 on: http://www.xconomy.com/boston/2012/03/15/how-the-ny-times-got-the-jobs-act-wrong/
[84] Ibid
[85] Ibid

Chapter 3 – Comparison with the Hong Kong IPO market

In 2011, Hong Kong ranked the world's largest IPO market, taking the lead in the world's IPO league for the third successive year. 89 IPOs were launched, raising $ 33,3 billion.[86] The Hong Kong stock market is the third-largest exchange by market capitalization and the second largest by number of total listings in the Asia-Pacific region.[87] Hong Kong securities markets belong to the most active and liquid ones in the world. East-Asian stock markets have a high trading velocity, which is the ratio between the annual turnover of shares to their market capitalization.[88] This reflects the market liquidity, which on its turn is crucial to a market because it facilitates efficient additional financing for listed companies and profit realization for investors.[89]

Being the international financial center of China, Hong Kong is the gateway to the global capital market for many Mainland Chinese enterprises. Not only Asian companies are attracted to list their shares on the Hong Kong Exchange (HKEx) but also companies from overseas are becoming increasingly interested. Listing at the HKEx gives them access to Asian investors and funds. Since the Hong Kong stock exchange has become a global IPO leader in the past years, it is interesting to compare it with the US IPO market. What is it that makes companies want to list their shares in Hong Kong? Is this due to the regulatory framework; is there legislation comparable with the JOBS act or are there other important factors?

3.1 Status quo of the Hong Kong IPO market

While the US IPO market declined over the past years, the Hong Kong stock exchange has become a global leader. In Q1 of 2012, ten companies have gone public in Hong Kong. Most of them were small but combined, they raised HK$ 3.3 billion (equals $ 425.49 million).[90] The largest IPO (also one of the largest offerings in the world in Q1 of 2012) was done by the Canadian based company Sunshine Oilsands. It was the largest one in Hong Kong since New China Life Insurance Co Ltd dual listed its shares in Hong Kong and Shanghai in December 2011, raising $ 1.9 billion. Despite Sunshine Oilsands recently faced a loss, many believe

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[86] Numbers derived from the Hong Kong Trade Development Council (HKTDC)
[87] H.C. Hwang, 'Hong Kong as an emerging IPO center and the international dimension of its stock market', July 1, 2010, p. 1
[88] Ibid, p. 4
[89] Ibid, p. 4
[90] M. Katsoris, 'State of the HK IPO market' at: *Asialegalblog.com*, March 18, 2012

they will recover and the share price will rise again because of the fact Sunshine Oilsands is teaming up with various energy companies and the Bank of China.[91]

IPO market watchers believe that if the global IPO market rebounds, it will be the Asia-Pacific region that will lead this recovery.[92] This is due to privatization of government entities and spin-offs of strong subsidiaries, which are accessing the capital markets now. Also consumer and materials sector companies are becoming more interested in launching an IPO. Chow Tai Fook is a nice example; this jewelry company launched its IPO in December 2011, raising $ 2 billion, which makes it the largest listed jewelry retailer in the world. Chow Tai Fook is a famous brand in Hong Kong, Macau and China; you can easily find 10 shops in Tsim Sha Tsui already, which is a district located north of Victoria harbor, opposite Central Hong Kong. Chow Tai Fook's jewelry (most of it is made of gold or jade) is very popular among China's 'new rich' and the company hopes to attract investors worldwide with the growing appetite for luxury goods of this group. Foreign luxury brands are also attracted to list their shares in Hong Kong; for example Prada raised $ 2.5 billion in June 2011 and lately, Graff Diamonds (a London based jewelry chain) filed its application to list its shares at the HKEx. The market has shown that especially high-end retailers are focused on Hong Kong to list their shares because they see it as the entry point into 'the future of the luxury goods market' as McKinsey calls it.[93] Issuers see Hong Kong as an efficient place to raise capital since there is an investor base available with cash and they hope to raise their profile among Chinese consumers by listing at the HKEx. It is common for many Western companies to list in Hong Kong when 30-40 % of their revenue is made in China.[94] Many expect that the world's center of gravity will shift to Asia in the future so it seems a logical step to direct your company towards that region.[95]

[91] Ibid
[92] U. Gupta, 'Will Asia-Pack lead global IPO rebound?', *Institutional Investor Magazine*, October 18, 2011
[93] M. Katsoris, 'State of the HK IPO market' at *Asialegalblog.com*, March 18, 2012
[94] Ibid
[95] Ibid

3.2 Attractiveness of listing in Hong Kong

Some go to Hong Kong with an empty suitcase to shop, others to list a company. Hong Kong does not only attract tourists and shoppers from all over the world but also many companies that want to have their shares listed at the HKEx. They see that Hong Kong is a significant source of capital since it is an important financial center in Asia and a gateway to China. It is also attractive to companies from the Mainland to list their shares at the HKEx. In 1993, the first state-owned Mainland Chinese enterprise listed its shares in Hong Kong. Since then, companies from Mainland China have considered Hong Kong as the gateway to the global capital market so they list there to raise equity capital from a wide range of investors, including many overseas investors. The participation of overseas investors has been stable over time; they account for 40 % of the overall participation since 2000.[96] Most of them are institutional investors from the US, the UK and Continental Europe.[97]

3.2.1 Foreign listings

When looking at foreign listings in Hong Kong, one could easily be deceived by the numbers. It seems there are not that much foreign companies that have listed their shares at the HKEx, however, this depends much on the definition of a 'foreign company.' Not all stock exchanges across Asia use the same definition: in Hong Kong, a listed company is counted as a foreign company if it is incorporated overseas AND has a majority of its business outside Hong Kong and China.[98] In Singapore, foreign listings are defined as companies whose principal places of business are outside Singapore. Furthermore, the HKEx considers Chinese companies as 'domestic' while, for example, Singapore considers them to be 'foreign'.[99] This, of course, affects the image we get on how international the Hong Kong stock exchange is. When using the first definition, there were only 11 foreign companies listed at the HKEx in 2009 which is a very low number considering the fact it is such a large exchange. However, when using another definition like the second one, it appears that 1219 'foreign' companies had listed their shares because then, 253 Chinese companies were also included as well as 955 Hong Kong companies that re-domiciled in either Bermuda or the Cayman Islands and listed in Hong Kong.[100]

[96] H.C. Hwang, 'Hong Kong as an emerging IPO center and the international dimension of its stock market', July 1, 2010
[97] Ibid, p. 9
[98] Ibid, p. 13
[99] Ibid
[100] Ibid

So it depends on which definition is used to determine if a company is foreign, however, it can be said that there is an increasing amount of foreign listings at the HKEx. Especially 2011 has been an important year for the HKEx's global expansion with 19 new international company listings.[101] Hong Kong is attracting overseas firms by making it easier for them to list by recognizing a larger number of countries. The Listing Committee of the HKEx has to approve jurisdictions to list on the exchange. This has to do with investor protection; only companies from jurisdictions that provide comparable investor protection are allowed to list on the HKEx.[102] To attract overseas firms by facilitating listing, the HKEx and the SFC (Securities and Futures Commission; independent statutory body that is responsible for the regulation of Hong Kong's securities and futures markets) issued the Joint Policy Statement Regarding the Listing of Overseas Companies (JPS). This is a long-term plan that aims at increasing the number of foreign listings. It contains clarification of the requirements in the Listing Rules and it provides a clear roadmap for potential issuers and their advisors to refer to regarding key shareholder protection matters.[103]

3.2.2 Significant sectors

An increasing number of foreign companies have listed their shares in Hong Kong. As stated before, luxury brands are attracted to list at the HKEx because of the growing appetite for luxury goods of the new rich. Another significant type of companies that are becoming more and more interested in listing their shares at the HKEx, are resources companies. Hong Kong is emerging as a new resource center due to its market liquidity and, also very important, its proximity to China.[104] China is the largest and fastest growing energy consumer in the world; it has a strong demand for metals (for example; gold) and energy sources. For the past years, the mining industry has been one of the most active sectors in stock exchanges. A few factors that contribute to this, are stimulation of governments that ensure continuous spending of metals and fuel (for example, projects for psychical infrastructure in China), the strong demand for coal in Asia, the fact that gold has become a hedge for investors due to the debt crisis and the shift in the debt-to-equity ratio of mining project financing which increased from 70 % debt and 30 % equity to even a 50-50 ratio in 2010.[105] Because of the fact that Asia has fast growing markets, many foreign firms (especially resources companies because of the strong demand for metals and luxury brands because of the increasing group of wealthy

[101] Newsletter HKEx January 2012
[102] H.C. Hwang, 'Hong Kong as an emerging IPO center and the international dimension of its stock market', July 1, 2010, p. 16
[103] Ibid, p. 17
[104] Ibid, p. 20
[105] Ibid, p. 17-18

customers), list their shares in Hong Kong because they expect that the demand for their shares will increase when they are closer to those fast growing markets.

3.3 Facilitation of IPOs in Hong Kong

So it is clear that Hong Kong is an attractive place to list shares for many Chinese companies as well as for overseas issuers. It has a liquid securities market and serves as a gateway to China and other parts of Asia. For now, it is interesting to see if Hong Kong is also doing something for small and medium enterprises that are planning to go public. Does Hong Kong have anything similar like the US that now has the JOBS Act to ease the path to an IPO?

What is remarkable when looking at the Hong Kong securities market is the distinction between the Main Board and the Growth Enterprise Market (GEM). The Main Board is meant for established companies to raise funds in the market. These companies are more mature than those on the GEM and have to meet higher profit or other financial standards requirements. When a company lists its securities on the Main Board, this can be done in the form of shares or depositary receipts (HDRs). HDRs are securities that are issued by a depositary and they represent underlying shares that were placed with the depositary (which has to be a suitably authorized and regulated financial institution acceptable to the HKEx) or its nominated custodian.[106] The use of HDRs may be convenient for (overseas) issuers since a larger investor pool can be reached: retail investors and smaller institutions usually do not want to buy and hold overseas shares directly because then, they have to deal with share registration procedures, tax reclaims, currency conversion and possibly investor registration procedures in the overseas jurisdiction.[107] These onerous procedures are handled by the depositary in the case of HDRs. The Growth Enterprise Market (GEM) is meant for startups that want to launch their IPO; it has much lower requirements compared to the Main Board. It is positioned as a second board and a stepping-stone towards the Main Board. Only shares can be listed, not HDRs. Since a substantial amount of the venture backed companies on the GEM are Chinese, it is interesting to first have a glimpse at venture capital in China.

[106] HKEx's website: http://www.hkex.com.hk/eng/rulesreg/listrules/listrulesfaq/Documents/drf_faq.pdf
[107] Ibid

3.3.1 Venture capital in China

Global venture capital firms have become increasingly interested in investing in innovative growth enterprises in China.[108] This already started in the 1990s when foreign VC got attracted by the tremendous growth opportunities in China. However, a weak institutional and legal framework, the difficulty of exiting and the Asian financial crisis pushed them back.[109] As stated in Chapter one, the possibility of an exit through an IPO from the investments is of utmost importance for a healthy venture capital industry. In the 1990s, it was extremely difficult to exit from investments in China through an IPO.[110] The two domestic stock exchanges in China (located in Shanghai and Shenzhen) were mainly directed towards state-owned companies and a huge barrier for VCs to exit was the fact that companies had to present three consecutive years of profit in order to be allowed listing their shares.[111] Another discouragement for exiting of venture capital investments through a listing in China was related to the way in which a VC investment was treated under Chinese company law: it would fall under the 'legal person shares' category when the portfolio company in which the investment was made went public in China. The transfer and trading of these legal person shares are largely restricted[112] so this was not an attractive prospect for venture capitalists.

From 1999, foreign VCs began to make use of SPVs (Special Purpose Vehicles) to exit their investment in a Chinese company through an IPO on a foreign stock exchange[113] to avoid the troubles inherent in launching an IPO in China. They transferred the assets/capital to an offshore SPV (located at tax havens like the Cayman Islands and Bermuda), which then launched the IPO at a foreign stock exchange. Such a structure provided foreign VCs with greater flexibility and liquidity while at the same time enjoying tax break on the investment returns.[114] However, in January and April of 2005, regulatory changes were made when China's State Administration of Foreign Exchange (SAFE) came up with two circulars that discouraged the use of SPVs as an exit. In short, these circulars required full approval of the SAFE for registering an offshore SPV and eliminated the tax benefits by making those who are establishing, restructuring or listing companies subject to China's domestic tax code.[115] This seriously harmed the foreign VC flow into China in the first two quarters of 2005.

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[108] X.E. Xu, 'Venture-backed IPOs and the exiting of venture capital in China', *Journal of Entrepreneurial Finance, JEF, ISSN 1551-9570, Vol. 11, Iss. 3*, pp. 39-55, p. 39
[109] Ibid, p. 40
[110] Ibid
[111] Ibid
[112] Ibid
[113] Ibid, p. 41
[114] Ibid
[115] Ibid

In October 2005, new initiatives were issued to restore the VC exit channels because the Chinese government saw that the regulatory changes made at the beginning of the year were harmful and they wanted to foster VC activity. In the new circular and some amendments to the other ones, they set out clearer registration procedures and VC transactions that involved offshore SPV structures were explicitly permitted.[116] As a result, the VC investment rebounded at the end of 2005.[117] Regulations in China were instable as can be derived from here; first they made regulatory changes that harmed foreign VC flow into China, then they saw the effects and decided these were undesirable so they changed it again. However, it is clear that China wanted to foster venture capital activity.[118] It is transforming from a centrally planned economy to a more market oriented economy and the Chinese government has become one of the most active ones to create venture capital investment programs.[119]

China was long considered to be weak in regulatory and legal aspects, due to, for example, the lack of intellectual property rights and instable regulations which can cause uncertainty for investors. This is an important fact because the investment behavior of VCs depends on the institutions of the countries were they operate.[120] There has been a lot of research on this and it seems that stronger institutions lead to more active involvement of the VC in the management of the portfolio companies and the use of innovative governance mechanisms, which leads in turn to more developed venture capital markets.[121]

China has taken steps to strengthen the regulatory framework to provide more certainty, protection and at the same time flexibility for foreign VC investments. Examples of changes that were made, are the revised 2006 Company Law, the revision of the 1986 PRC Law on Wholly Foreign Enterprises and the 2003 Venture Capital regulations ("Regulations in the administration of foreign-invested venture capital enterprises").[122] This last one is important since it allowed foreign VCs to enter the Chinese market by making use of various structures such as the wholly foreign enterprise (WFOE; which is a limited liability company that is wholly owned by foreign investors), limited partnerships or joint ventures.[123] Another

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[116] L. Ross, 'New SAFE "Round Trip Investment" Circular lightens the regulatory burden on venture capital investments in China', *Wilmer Cutler Pickering Hale and Dorr Antitrust Series* January 2006, Working Paper 8
[117] X.E. Xu, 'Venture-backed IPOs and the exiting of venture capital in China,' *Journal of Entrepreneurial Finance, JEF, ISSN 1551-9570, Vol. 11, Iss. 3*, pp. 39-55, p. 41
[118] Ibid, p. 41
[119] D. Guo, 'Production Modes in China's Venture Capital Finance Sector: An Empirical Study on Stage Financing in China', *School of Business, The University of Hong Kong*, p. 2
[120] Ibid,
[121] Researches conducted by, for example, Kaplan, Cummings, Jeng and Wells; described in D. Guo, 'Production Modes in China's Venture Capital Finance Sector: An Empirical Study on Stage Financing in China', *School of Business, The University of Hong Kong*, p. 2
[122] X.E. Xu, 'Venture-backed IPOs and the exiting of venture capital in China', *Journal of Entrepreneurial Finance, JEF, ISSN 1551-9570, Vol. 11, Iss. 3*, pp. 39-55, p. 41-42
[123] Ibid

important regulatory change was the revised 2006 Company Law since the minimum capital requirement was substantially reduced, the recognized contribution of intangible assets such as intellectual property rights was enhanced and the entry barriers for venture-backed entrepreneurial activities in China were lowered.[124]

The VC market in China is growing fast; in 2011, 382 new VC funds raised $ 28.2 billion for investments into Chinese VC backed companies.[125] China hit an all-time record that year in both number of investments and investment amount.[126] It is likely that this investment pace will continue because of the favorable exit environment. Opposed to the 1990s, when it was difficult to exit investments in a Chinese company through an IPO, the Chinese government has recently set new policies aimed at stimulating the growth of the VC industry.[127] As described before, the possibility of an exit through IPO is essential for a sound venture capital market. Foreign venture capitalists began to make use of an offshore SPV to exit their investments in a Chinese company on a foreign stock exchange. Listings on an overseas exchange such as NASDAQ or NYSE in the US were popular for a long time. However, this also comes with difficulties and costs because, for example, you have to comply with SOX and you face rigorous listing requirements with respect to size, shareholder base and financial performance.[128] Because of this, Chinese VC backed companies have looked beyond the US stock exchanges. Listing on domestic stock exchanges such as the Shenzhen Stock Exchange became popular: 87% of VC backed IPOs took place on domestic stock exchanges.[129] Due to a more favorable exit environment, the majority of exits in China occurred through an IPO in 2011: 356 of the total of 456 exits (68%) were IPOs and 48% of those IPOs were done by VC backed companies.[130]

Listings on overseas markets other than the US also became more popular; especially Hong Kong and Singapore since these are two main financial centers that are cultural closely related to China. Hong Kong is a favorable option for listings of Chinese companies that intend to avoid the high compliance costs related to US listings.[131] There are two types of shares of Mainland Chinese companies that can be listed in Hong Kong: ‘H-Shares’ and ‘Red Chips’. H-shares are issued by companies that are incorporated in Mainland China and their listing in

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[124] Ibid and J. Wilson and L. Tao, ‘China’s new company law’, *The China Business Review, March/April 2006, 33*, p. 30
[125] Zero2IPO report of January 2012
[126] Ernst & Young’s *Global Venture Capital insights and trends report 2011*
[127] Ibid
[128] X.E. Xu, ‘Venture-backed IPOs and the exiting of venture capital in China’, *Journal of Entrepreneurial Finance, JEF, ISSN 1551-9570, Vol. 11, Iss. 3*, pp. 39-55, p. 42
[129] Ernst & Young’s *Global Venture Capital insights and trends report 2011*
[130] Zero2IPOreport of January 2012
[131] X.E. Xu, ‘Venture-backed IPOs and the exiting of venture capital in China’, *Journal of Entrepreneurial Finance, JEF, ISSN 1551-9570, Vol. 11, Iss. 3*, pp. 39-55, p. 43

Hong Kong is approved by the China Securities Regulatory Commission (CSRC).[132] Red Chips are issued by enterprises that are controlled by Mainland Government entities but incorporated outside of the Mainland.[133] They are internationally incorporated (for example, on the Cayman Islands) and listed at the HKEx. As set out before, the HKEx consist of the Main Board and the Growth Enterprise Market (GEM); together they compromise the HKEx securities market.[134] H-shares and Red Chips can be listed on both the Main board and the GEM. Between 1993 and 2006, 146 Chinese backed IPOs were launched on the Main Board and 50 on the GEM.[135] Since the GEM is a unique market with at least 70 % of the IPOs launched by technology startups,[136] it is interesting to take a look at it.

3.3.2 The Growth Enterprise Market in Hong Kong (GEM)

The GEM has been established in November 1999. It was intended to provide capital formation opportunities for growth companies.[137] Since these companies usually have no track record of profitability and not that much resources, a listing on the Main Board would not be possible. Such companies are often more risky to invest in and cannot fulfill the requirements of a listing on the Main Board. The GEM facilitates these startups that are planning to do their IPO. In July 2008, the GEM was repositioned as a second board and a stepping-stone to the Main Board.[138] The objective is that a GEM listing is of transitional nature; it can be seen as a preparation for a Main Board listing. While there is no automatic transfer from the GEM to the Main Board, a GEM-listed issuer can apply to the Listing Division for a transfer to the Main Board if he fulfills the following requirements: meeting the Main Board admission criteria, has been listed on the GEM for a full financial year and no subject of disciplinary investigations by the Exchange for serious or potential serious rule breaches during the preceding 12 months.[139]

There are several ideas behind the development of the GEM, including the desire to facilitate growth potential companies that otherwise would not qualify for a Main Board listing as stated above. Another aim is to offer an independent and recognized market for especially

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[132] HKEx's website: http://www.hkex.com.hk/eng/global/faq/hkex%20markets.htm
[133] Ibid
[134] Ibid
[135] X.E. Xu, 'Venture-backed IPOs and the exiting of venture capital in China', *Journal of Entrepreneurial Finance, JEF, ISSN 1551-9570, Vol. 11, Iss. 3*, pp. 39-55, p. 43
[136] P.T. Chan, F. Moshirian, D. Ng and E. Wu, 'The underperformance of the growth enterprise market in Hong Kong', *Research in International Business and Finance, Volume 21, Issue 3,* September 2007, pp. 428-446, p. 428
[137] HKEx's website: http://www.hkex.com.hk/eng/global/faq/hkex%20markets.htm
[138] Ibid
[139] Ibid

innovative tech companies with high growth potential to list.[140] Technology development is also one of the reasons behind the introduction of the GEM: it can contribute to the Government's initiative to promote the development of high technology and high value-added industries in Hong Kong.[141] The GEM also promotes the development of venture capital investments by providing a good exit channel.[142]

The GEM already calls itself a 'buyers beware' market for informed investors.[143] Since the companies that list their shares on this market do not have a solid track record (most of them are technology startups) a higher investment risk is attached to them. Therefore, the GEM is more suitable for professionals and sophisticated investors because it is needed that potential investors are aware of the fact that they are investing in more risky companies. Professionals are more likely to make a deliberated decision after due and careful consideration.

The listing requirements of the GEM are lower and more suitable for emerging companies that do not have great resources yet. When an issuer wants to list its shares on the GEM, it must fulfill certain financial requirements, the company must be incorporated in an acceptable jurisdiction, the accounts must be prepared in accordance with certain accounting standards, it has to meet the minimum market capitalization and the spread of shareholders must be in accordance with the Listing Rules.

Concerning the financial requirements, an issuer should have a trading record of at least two financial years compromising a positive cashflow generated from operating activities in the ordinary and usual course of business of at least HK$ 20 million in aggregate for the two financial years immediately preceding the issue of the listing document.[144] Furthermore, there is a market cap of at least HK$ 100 million at the time of listing. It is also required that throughout the two full financial years, the management consist of substantially the same people and that there is a continuity of ownership and control throughout the full financial year immediately preceding the issue of the listing document. However, exceptions can be made in terms of a shorter record period and waive or vary the ownership and management requirements for certain types of companies such as newly-formed 'project' companies and natural resources exploitation companies, supported by reasons acceptable to the Exchange.[145]

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[140] P.T. Chan, F. Moshirian, D. Ng and E. Wu, 'The underperformance of the growth enterprise market in Hong Kong', *Research in International Business and Finance, Volume 21, Issue 3,* September 2007, p. 428-446, p. 430
[141] Ibid
[142] http://www.hkgem.com/aboutgem
[143] Ibid
[144] Ibid
[145] Summary of basic listing requirements at: http://www.hkex.com.hk/eng/listing/listreq_pro/listreq/equities.htm

In comparison, a Main Board applicant has to fulfill heavier financial requirements. It must have a trading record of not less than three financial years and meet one of the following financial criteria: the profit test, which means that the profit should be at least HK$ 50 million in the last 3 financial years, with profits of at least HK$ 20 million in the most recent year and aggregate profits of at least HK$ 30 million in the 2 years before that, the Market Cap/Revenue test where the market cap must be at least HK$ 4 billion at the time of listing and the revenue at least HK$ 500 million for the most recent audited financial year or the Market Cap/Revenue/Cashflow test which requires that the market cap is at least HK$ 2 billion at the time of listing, the revenue at least HK$ 500 million for the most recent audited financial year and that there is a positive cashflow from operating activities of at least HK$ 100 million in aggregate for the three preceding financial years.[146]

The jurisdiction of the issuer that desires to list its shares on the GEM must be an acceptable jurisdiction according to the Listing Rules. When the issuer is incorporated or otherwise established under the laws of Hong Kong, the People's Republic of China, Bermuda or the Cayman Islands it is qualified as being a suitable jurisdiction. Applicants that are not incorporated in one of these jurisdictions may be accepted on a case-by-case basis and one of the main requirements is that their jurisdiction provides at least the same shareholder protection as Hong Kong. There is a roadmap[147] that compromises a schedule of these shareholder protection matters so applicants can use that to determine themselves if the shareholder protection in their own jurisdiction is at least equivalent to those required under Hong Kong law.[148]

For both Main Board and GEM applicants it is required to prepare the accounts in accordance with either Hong Kong Financial Reporting Standards or International Financial Reporting Standards. Concerning Main Board applicants, it may be acceptable only under certain circumstances that the accounts of an overseas-incorporated issuer are prepared in accordance with US GAAP. For GEM applicants, this is acceptable if the company is already listed or will be simultaneously listed, on either the NYSE or NASDAQ.[149]

The minimum market capitalization is set at HK$ 100 million for a GEM applicant, which is considerable lower than the HK$ 200 million that applies to a Main Board applicant. Also the market capitalization of the public float (the securities held by the public) can be lower for a GEM applicant (HK$ 30 million) than for a Main Board applicant (HK$ 50 million). Also the

[146] Ibid
[147] In the attachment to the Joint Policy Statement dated 7 March 2007
[148] Summary of basic listing requirements at: http://www.hkex.com.hk/eng/listing/listreq_pro/listreq/equities.htm
[149] Ibid

requirements concerning the spread of shareholders differ: on the Main Board, the securities in the hands of the pubic should be held among at least 300 holders while on the GEM this number is set at 100 persons. Concerning the offering mechanism, a GEM applicant is free to decide which offering mechanism to use and listing by placing only is permitted. A Main Board applicant is not free to choose: listing by placing only is not permitted in the case that it is likely that there will be significant public demand for its securities. If this is the case, the Practice Note 18 of the Main Board Listing Rules on Initial Public Offer of Securities sets out procedures to follow in the allocation of shares.[150]

As can be derived from the short summary of listing requirements above, companies that want to list their shares on the GEM face favorable requirements compared to a listing on the Main Board. Especially the lower financial requirements are very beneficial for emerging companies. Since startups usually do not have a record of profitability, it is very helpful for these companies that the GEM does not require this as a listing condition. This has the effect that the future performance of these companies is likely to be uncertain. As stated before, because of this higher risk, the GEM is designed for professional investors. Because the GEM operates on a 'buyers beware/let the market decide' philosophy, there is a strong disclosure regime in order to provide the sophisticated investors with the information they need to make an elaborated decision. The rules and requirements in this disclosure regime are designed to foster a self-compliance culture by the listed issuers and sponsors.[151] A GEM applicant is required to disclose in detail its past business history and its future business plans; these are key components of the listing documents. Furthermore, a GEM issuer has to make half yearly comparison between its business progress and the business plan for the first 2 financial years after listing. This has to be published in addition to half yearly and annual accounts.[152]

3.3.3 Performance of the GEM

The description above is of the GEM in its current form. In the period short after the launch of the GEM, it was not an immediate success. Some even called it a failure because it had not attracted many companies that wanted to list their shares. For example, in 2005, the GEM only had 10 new listings.[153] The GEM in Hong Kong was not the only one: in other jurisdictions similar initiatives were launched. They all wanted to follow the successful

[150] Ibid
[151] http://www.hkgem.com/aboutgem. A sponsor is a corporation or an authorized financial institution (licensed or registered by the SFC) appointed by the issuer for its listing proposal. The sponsor is responsible for preparing the company for listing, for lodging the formal listing application and all supporting documents with the Exchange.
[152] Ibid
[153] Discussion paper of the HKEx of January 2006, p. 23

NASDAQ but most of them did not succeed. This can be caused by the fact that they cannot control the quality of listed companies or by investor speculation.[154] It is stated that Hong Kong faced the same difficulties as the UK did when attempting to establish a successful growth market.[155] But when they came up with the AIM (Alternative Investment Market in London), which was lighter regulated and more based on disclosure, it became successful. Hong Kong had to do something to compete with the AIM because also many domestic and PRC companies went to list their shares there instead of close to home on the GEM.[156]

Since 2008, the GEM is positioned as a second board and a stepping-stone to the Main Board. The GEM has followed the example of the AIM by adopting a disclosure-based regime and fostering a self-compliance culture by the listed issuers and sponsors as described above. It can be said now that the performance of the GEM increased since then. In 2010, 7 companies turned to the GEM to raise capital and 12 companies transferred from the GEM to the Main Board. In 2011, these numbers were respectively 13 and 12.[157] In January 2012 already 3 successful GEM IPOs were launched. In the past 4 years, around 50 companies in aggregate transferred from the GEM to the Main Board.[158] This is evidence that companies make increased use of the GEM as a stepping-stone to the Main Board; it has become more popular. There has been a 'springboard' effect: in the depressed market of recent years, companies that are listing on the GEM are favored by the rules that allow a transfer to the Main Board.[159]

Several factors have accelerated GEM IPOs in recent years and in a depressed market, these factors are of particular effects. One of these factors relates to the lower listing requirements of the GEM in comparison with the Main Board. Especially the lack of a profit requirement in the GEM rules and a lower cashflow requirement are favorable to companies wishing to obtain a listing during economic turmoil because it helps to lessen the burden for companies with no strong cashflow which is not uncommon in a depressed time.[160] Another issue is the decline in number of IPOs on the Main Board (from 94 in 2010 to 76 in 2011). Under the public offering mechanism of the Main Board, the IPO offering price is determined based on the applicant's profitability. Because of the depressed market, this has the effect that there is a decline in number of IPOs.[161] In contrast, the GEM allows for IPOs by placing. This is an

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[154] ChinaDaily.com.cn, *How far will the growth enterprise market go?,* May 13, 2009
[155] Discussion paper of the HKEx of January 2006
[156] Ibid
[157] Numbers derived from: PwC HK, 'Hong Kong tops leading IPO destination for three consecutive years', press release of January 4, 2012
[158] BDO Limited, 'GEM shines in a recession and depressed market? Possible rebound of the IPO market towards end of 2012?', press release of February 5, 2012
[159] Ibid
[160] Ibid
[161] Ibid

easier way to launch compared to the public offering mechanism of the Main Board. The difficulty of launching an IPO on the Main Board causes a shift to the GEM.

So despite of a depressed market, the GEM is doing quite well. It is expected that overseas companies will continue to list their shares in Hong Kong because its capital market is still regarded as the primary source to obtain funding from Mainland investors.[162] The GEM seems to play a favorable role in this.

3.4 Conclusion

At the beginning of this chapter it was asked what makes companies want to list their shares in Hong Kong. It can be concluded that this must be a combination of factors. The GEM does play a role in this by facilitating emerging companies that seek a listing. This is reached by lower (financial) requirements whilst there is a strong disclosure regime because of the high investment risk attached to these companies. Because of this risk, it is also a market that is more suitable for sophisticated investors ('buyers beware'). Concerning easing the path to an IPO by lowering the (financial) requirements (because the 'normal' requirements are mostly not suitable for startups), resemblance can be made to the JOBS Act. Also the transitional nature of a GEM listing corresponds to the on-ramp for emerging growth companies in the JOBS Act, which is also intended to be transitional since the exemptions end after 5 years. However, the 'buyers beware' philosophy and the self-compliance culture by the listed issuers and sponsors can not be found back in the JOBS Act, especially not when it comes to the part of crowdfunding since that usually involves a large amount of retail investors.

Another reason why listing in Hong Kong is popular is more general. There is sufficient liquidity in the market and there is a continuous growth of China's economy. Since Hong Kong is geographically so close to China and also has strong cultural ties with the country, it is seen as a gateway into China (and vice versa for Mainland enterprises seeking overseas public capital). Because of the continuous growth, China is demanding more and more energy and people become more interested in luxury goods. Therefore, resources companies and luxury brands in particular are attracted to list in Hong Kong since a significant part of their revenue is now made in China. They desire to raise their profile among Chinese customers and there is an investor base available.

[162] Ibid

Furthermore, it is not too hard for an overseas issuer to list a company in Hong Kong (either on the Main Board or on the GEM). To overcome difficulties such as the requirement that your jurisdiction must offer at least the same shareholder protections as under Hong Kong law, you can list your company by restructuring in Hong Kong, Bermuda or the Cayman Islands. Also beneficial are the tax exemptions in capital gains and offshore profits of course.

I think the combination of China's economic growth, the key position in the region and the close cultural ties with the mainland contribute to the fact that Hong Kong is such a popular place to launch an IPO. Favorable listing requirements of the GEM certainly support this when it comes to emerging companies and it seems that the GEM serves well as a stepping-stone to the Main Board.

Chapter 4 – Analysis of the situation in Europe

The problems of the Eurozone are frequently discussed in the news. Europe is suffering from the global financial crisis and especially the uncertainty of the Eurozone disrupts the European capital markets because it causes huge uncertainty. This is caused by a sovereign debt crisis that has its roots in 2008 when Iceland's banking system collapsed. In the summer of 2011, the sovereign debt crisis hit the Eurozone. Many banks in Europe own a significant amount of sovereign debt. The probability of default on sovereign debts increased and in combination with macroeconomic misalignments, this caused problems.[163] In several countries within the EU, financial institutions collapsed and the government's debt increased. Some banks (like the Dutch-Belgian bank Fortis) were saved but this cost the governments huge amounts of money. This would not be all of a huge problem if the economy kept on growing but Europe has also been hit by an economic recession which decreased fiscal revenues for the government while at the same time increased expenditures in the form of, for example, unemployment benefits.[164] The debt of several countries within the Eurozone was downgraded by rating agencies and Greece's debt was even moved to junk status. This further decreased the confidence in European economies and companies. Since jobs created by Small and Medium Enterprises (SMEs) count for 85 % of all new jobs in the EU for the past 5 years[165], it is interesting to see what the EU is doing to facilitate emerging companies in attracting capital. Is Europe doing anything to create a strong IPO market and how are startups/SMEs facilitated?

4.1 The European IPO market

In the first half of 2011 it seemed that the European IPO market had a positive start since a total of € 16.3 billion was raised. However, the last half of that year this decreased to € 10.2 billion because the economic uncertainty in Europe became larger. The Eurozone sovereign debt crisis caused market volatility and increased uncertainty with the result that many IPOs were delayed or postponed.[166] However, it was not all that bad because in 2011, 430 IPOs were launched in total across Europe, which is an increase in volume of 13%. Despite that only a quarter of the IPOs was launched in London, more than half of all the capital raised across Europe (€ 14.1 billion) was generated there on the London Stock Exchange. Natural

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[163] J.I. Haidar, 'Sovereign credit risk in the Eurozone', *World Economics, Economic & Financial Publishing, Volume 13, Issue 1*, 2012, pp. 123-136
[164] Ibid
[165] According to a study carried out at the request of the EU Commission: *the SME Performance Review*
[166] PwC's IPO Watch Europe 2011, available at : http://www.pwc.co.uk/audit-assurance/publications/ipo-watch-europe-2011.jhtml

resources companies dominated the London listings, raising € 8.2 billion and accounting for 58 % of the transactions.[167]

In Q1 of 2012, it looked like there was a recovery of the IPO market because a number of high profile deals were concluded in the beginning of this year. Some stability has entered the markets for the first time in a while and 58 IPOs were launched across Europe, raising € 2.3 billion.[168] This is an improvement compared to the last quarter of 2011 when only € 0.9 billion was raised. The most remarkable IPOs were launched by Ziggo which is a private equity backed Dutch cable operator and DSKH in Zurich, a trade and marketing company. In total, they raised € 1.5 billion and accounted for 65 % of the total proceeds raised that period.[169]

4.2 Venture capital in Europe

It is also interesting to take a look at the venture capital market in Europe since it is quite different from the market in the US. The definition of venture capital is broader than the US one. Besides the investment by venture capital funds in high-growth, high-risk and often high-technology firms also 'buyout' financing is included in the European definition.[170] This means that a mature firm's managers are enabled to acquire the firm from its current owners. In Europe, venture capital firms often provide financing for this. The US is often seen as the example when it comes to venture capital: they have a stock market centered system and a strong venture capital industry.[171] Venture capital as an asset is often seen as a failure in Europe.[172] Institutional investors such as pension funds that would normally put pension fund money into venture funds are against venture capital as an asset class.[173] Therefore, venture capital funds do not make much money from that. There has been a consistent underperformance of European VC funds compared to their US counterparts.[174] This is due to several factors, including the difference in stock market performance, labor market regulations and contract and tax regulations.[175] However, governments do like venture capital: VC firms from continental Europe and the UK raised € 4 billion last year and 40 % of that

[167] Data also derived from PwC's IPO Watch Europe 2011
[168] Pwc's IPO Watch Europe Q1 2012
[169] Data derived from IPO Watch Europe Q1 2012
[170] R.J. Gilson and B.S. Black, 'Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets', *Journal of Financial Economics, Vol. 47*, pp. 243-277, 1998, p. 3
[171] Ibid, p. 3
[172] J. Meyer, 'Venture capital – a European story' in: The Financial Times, April 16, 2012
[173] Ibid
[174] R. Kräussl and S. Krause, 'Are Particular Industries More Likely to Succeed? A Comparative Analysis of VC Investment in the U.S. And Europe', *The Oxford Handbook of Venture Capital*, D. Cumming, ed., Oxford University Press, p. 2
[175] Ibid

came from government agencies. They support venture capital in several ways: by tax incentives, by investing directly through state-backed organizations and by injecting capital into privately managed funds.[176] A good example of that last initiative is the European Investment Fund, which is funded by most Member States. In 2011, it pumped a record of € 1 billion into venture and growth capital.[177]

In 2011, the VC industry in Europe suffered through some of the worst volume since 2004: fundraising fell from $ 3.4 billion for 51 funds in 2010 to $ 3.0 billion for 41 funds in 2011 and from $ 6.7 billion invested in 1253 rounds to $ 6.1 billion in 1012 rounds.[178] However, there are now signs that the VC industry is recovering but the activity remains below pre-crisis levels.[179] The countries that invest the most in venture capital in Europe are the UK and Ireland. Combined, they invested $ 1.7 billion in 274 deals in 2011 although this is less than the amounts they invested in 2010 ($ 2.6 billion). France ranks third with an amount of $ 1 billion invested in 217 deals in 2011.[180]

4.2.1 Europe's efforts to ease access to capital

There is no integrated venture capital market in Europe (yet) so the regulations vary from country to country. However, the EU desires to unify the venture capital market because that will help innovative small businesses to get access to financing easier.[181] At this time, cross border investment is still quite difficult because of all the different national administrative, regulatory and tax rules. This makes it costly and time consuming when a fund wants to invest in several EU countries. The EU therefore is promoting cross border investment; this will help SMEs to get easier access to venture capital. The goal is that by 2012, VC funds established in any Member State can invest freely throughout the EU.[182] The EU is trying to realize this by the Commission's recent Communications on Europe 2020 Strategy, the Small Business Act, Innovation Union and the Single Market Act. Furthermore, it would help if Member States removed tax obstacles in order to make sure that tax treatment in different jurisdictions would not lead to double taxation.[183]

The Communication on Europe 2020 Strategy contains five targets for 2020 in order to get Europe out of the crisis and back on track. The main priorities are smart growth (developing

[176] Blog 'European Venture Capital: Venturecrats' published at *The Economist's* website, April 19, 2012
[177] Ibid
[178] Ernst & Young's Global Venture Capital insights and trends report 2011
[179] Ibid
[180] Data also derived from Ernst & Young's Global Venture Capital insights and trends report 2011
[181] European Commission's website: http://ec.europa.eu/enterprise/policies/finance/risk-capital/venture-capital/
[182] Ibid
[183] Ibid

an economy based on knowledge and innovation), sustainable growth (promoting a more resource efficient, greener and more competitive economy) and inclusive growth (fostering a high-employment economy delivering social and territorial cohesion).[184] The Commission has put forward several flagships of which the most important for promoting cross border investment are the 'Innovation Union' and 'An industrial policy for the globalization era.' The idea behind the Innovation Union is to improve the framework conditions and access to finance for research and innovation. This will have the result that innovative ideas can be turned into products and services that create growth and jobs.[185] An industrial policy for the globalization era should improve, especially for SMEs since they are great job creators, the business environment and support the development of a strong and sustainable industrial base that is able to compete globally.[186] Under this initiative, the Commission will (amongst many other things) achieve the improvement of the business environment for SMEs by reducing the transaction costs for doing business in Europe, by promoting of clusters and by improving affordable access to finance.[187] These two flagships combined with the other five that are related to for example improvement of labor markets and fighting poverty, commit both the EU and the Member States.

In the Commission's Communications on Europe 2020 Strategy, it already proposed action to tackle bottlenecks in the single market. From 1992, the single market brought benefits and created opportunities because of the free movement of goods, services, capital and people. However, this does not always happen that smoothly. In relation to cross-border investment, the free movement of capital is important. It is a beautiful idea but due to all the different national administrative, regulatory and tax rules it is still difficult to invest in a number of countries at the same time. Therefore, SMEs cannot fully benefit from the single market because cross border investment is hard for investors. Access to the single market had to be improved for SMEs and entrepreneurship must be developed. This can be reached by concrete policy initiatives, including a simplification of company law (bankruptcy procedures, private company statute, etc.), and initiatives allowing entrepreneurs to restart after failed businesses.[188]

What follows was the adoption of the Single Market Act on April 13, 2011. It consists of twelve instruments that boost growth and strengthen confidence. The most important ones as regards to SMEs are the 1st and the 11th instrument. The first instrument is improving the

[184] Communication from the Commission, 'Europe 2020: A strategy for smart, sustainable and inclusive growth', p.5
[185] Ibid, p. 6
[186] Ibid
[187] Ibid, p. 17
[188] Ibid, p. 20

access to finance for more than 20 million SMEs by introducing legislation that will make it easier for venture capital funds to invest in other Member States. It will make sure that a VC fund that is established in one Member State can invest freely in any other Member State. This could be done by creating European passport for VC funds, which will allow them to do so.[189] The 11th instrument is improving the regulatory business environment by, for example, simplifying the Accounting Directive with regards to financial information obligations and reduction of administrative burden. This can save €1.5 billion per year for 1.1 million small companies and €5.2 billion per year for 5.9 million micro-enterprises.[190]

The Small Business Act for Europe was adopted in 2008 and puts into place a comprehensive SME policy framework for the EU. It applies to all independent companies with less than 250 employees, which is 99 % of all European businesses.[191] The main purpose is to minimize the regulatory burden for SMEs by, for example, exempting SMEs from existing EU legislation or by introducing special regimes that reduce the regulatory burden for them.

Other efforts of Europe include the publishing of a practical guide that provides information on how to access over € 50 billion of public finance in 27 Member States. This fosters entrepreneurship by facilitating access to finance. It contains information on different national and regional financing programs and how to apply.[192] Also a European wide training campaign is set up for the Entrepreneur Europe Network to help SMEs to obtain finance.[193] The EU is also preparing an Entrepreneur Action Plan, which will be published in the autumn of 2012. This is meant to unlock the entrepreneurial potential of citizens by removing some of the obstacles to entrepreneurial activities. It may include the facilitation of transfer of businesses, efficient bankruptcy procedures and offering second chances and entrepreneurship programs for young people during their education.[194] It is clear that the EU has confidence in SMEs, entrepreneurship and innovation to overcome the economic difficulties it is facing these times.

4.2.2 Exits

Determinant for a successful venture capital market is the availability of an exit of the investment through an IPO. There has to be a well-developed stock market that permits the

[189] Single Market Act
[190] Ibid
[191] Small Business Act for Europe
[192] Website of the European Commission; Enterprise and Industry News
[193] Ibid
[194] Ibid

VC to exit.[195] It is clear that in the US, there have been more successful exits from VC than in Europe. A research conducted in the period between 1985 and 2008 found that of 34.088 VC backed companies in the US, 13.34 % successfully launched an IPO through which the investors could exit. In comparison: of the 17.909 VC backed firms in Europe, 7.70 % provided an exit through IPO.[196] Stock market conditions have a huge influence on IPOs since VCs plan their exit when the valuations are at the highest.[197]

There are important differences between the US and the European VC market and this is mainly due to the fact that the markets that are relevant for VCs are less liquid in Europe.[198] Furthermore, the VC market in Europe is still quite young compared to the US. The main differences are the duration of exit stage, the use of convertible securities, the replacement of former management, the average of financing rounds and syndication.[199] VCs in Europe have to look for a longer time for parties to sell their shares to: in the US the mean exit stage has a duration of 7.4 months whilst in Europe, this is 8.5 months. This is related to the exit markets' liquidity. Also the replacement of key personnel is more difficult in Europe because of less liquid human resources markets.[200] The use of convertible securities (especially convertible preferred stock) in VC contracts is one of the most remarkable differences between the US and Europe. In Europe, there is a significant lower use of this kind of securities than in the US. To illustrate this: in 79.8 % of the financing rounds in the US, the main securities that had been used were convertible preferred stock.[201] Reasons to use these securities relate to mitigating the possible agency conflicts between the VC and the entrepreneur. When using convertible preferred stock, the VC has often certain control rights and the right to decide on exit. It is also a protection against the downside risk of investments since it provides seniority rights over straight equity.[202] In the unfortunate situation that the venture is liquidated, all the cash flow and liquidation value go to the VC. This provides a huge incentive for the entrepreneur to use his best efforts to make the firm a success. Therefore, it is likely that the use of convertible securities induces an increase in the probability of going public.[203]

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[195] A. Schwienbacher, 'An empirical analysis of venture capital exits in Europe and the United States', *University of Namur, Center for Research in Finance and Management*, July 2002, p. 3
[196] R. Kräussl and S. Krause, 'Are Particular Industries More Likely to Succeed? A Comparative Analysis of VC Investment in the U.S. And Europe', *The Oxford Handbook of Venture Capital*, D. Cumming (ed.), Oxford University Press 2012, p. 6
[197] J. Lerner, 'Venture capitalists and the decision to go public', *Journal of Financial Economics 1994, Issue 35*, pp. 293 - 316
[198] A. Schwienbacher, 'An empirical analysis of venture capital exits in Europe and the United States', *University of Namur, Center for Research in Finance and Management*, July 2002, p. 4
[199] Ibid, p. 16
[200] Ibid, p. 16-17
[201] S. Kaplan and P. Strömberg, 'Financial contracting theory meets the real world: An empirical analysis of venture capital contracts', *University of Chicago*, 2001, p. 4
[202] A. Schwienbacher, 'An empirical analysis of venture capital exits in Europe and the United States', *University of Namur, Center for Research in Finance and Management*, July 2002, p. 10
[203] Ibid, p. 10

Since the IPO markets are less liquid in Europe, an IPO is also more risky. When the IPO is unsuccessful, there are risks of negative reputation. Researchers found[204] that 11 % of the VC funds in Europe has a strict preference for IPO has exit compared to 29 % in the US. In Europe, the preference for a trade sale is apparent: 39 %. This is much higher than in the US where only 24 % has a strict preference for a trade sale. Due to several factors above all relating to the less liquid IPO market in Europe, VCs often engage in a trade sale in stead of IPO.

4.3 Interesting markets in Europe for VC backed companies

Despite the fact that VCs in Europe do not exit through an IPO as often as their US colleagues do, their performance overall is good: there is evidence that VC-backed IPOs in Europe generate positive returns and that there was a positive performance during the period from 1996 to 2010.[205] Also in Europe there are attractive stock markets for venture-backed companies. In 1996, EASDAQ (European Association of Securities Dealers Automatic Quotation System) was established in Brussels as the European equivalent of the famous NASDAQ in the US. In 2001, NASDAQ acquired a controlling interest in EASDAQ and it was renamed NASDAQ Europe. However, in 2003, it was shut down because of the burst of the dot-com bubble. In 2007, it made a comeback as Equiduct; an electronic trading platform based on the technology of the former EASDAQ.

In most European countries, new stock market segments special fitted to entrepreneurial and technology driven startups were opened between 1996 and 2000.[206] These were intended to offer attractive exit opportunities for VCs. Mandatory provisions contained in, for example, the European Union Directives increase the transaction costs of listed firms.[207] Exchange regulated market segments (such as the AIM, see below) escape most of those burdensome rules. It is remarkable that VC backed IPO activity is concentrated in certain countries within Europe. The capital markets that attracted the most IPOs in the period from 1996 and 2010 are the UK, Germany and France, which count all together for 70 % of all VC-backed firms that went public that year.[208]

[204] In their survey amongst 104 European VC funds and 67 US based VC funds: A. Schwienbacher, 'An empirical analysis of venture capital exits in Europe and the United States', *University of Namur, Center for Research in Finance and Management*, July 2002
[205] W. Bessler and M. Seim, 'European Venture-backed IPOs: An empirical analysis', March 7, 2011, p. 1
[206] Ibid, p. 3
[207] J. M. Mendoza, 'Securities regulation in low-tier listing venues: the rise of the Alternative Investment Market', *Fordham Journal of Corporate & Financial Law, Vol. 3, No. 2*, 2008, p. 262
[208] Ibid, p. 6

London has besides the well-known LSE (London Stock Exchange) the more lightly regulated AIM (Alternative Investment Market). It has the status of an 'exchange regulated market' which means that it is not regulated by the Markets in Financial Instruments Directive (MiFID), but that it is subject to a body of rules laid down by the market operator. The AIM attracts mainly smaller companies since it has lower listing standards and the ongoing requirements for already listed companies are also lighter.[209] It also makes use of the 'Nominated Advisors' (Nomads) whose role it is to take responsibility for coordinating the admission process and carrying out extensive due diligence to make sure that the company is suitable for AIM.[210] This combination of a 'Nominated Advisor' and lower (ongoing) listing requirements has been a success since the AIM has arisen as one of the world's fastest growing exchanges and other countries tried to follow this approach. An example is the Hong Kong Growth Enterprise Market as discussed in the previous chapter. The AIM does not only attract companies from Europe but also many US startups are interested. Especially in the period from 2002 to 2007, the time after the dotcom bubble, regulations became stricter and made it more costly and cumbersome to list on regular exchanges. Therefore, also US startups found their way to the AIM during this period since this market is a principle-based venue instead of regulated by strict listing rules. The Nomads play an important role is this; the system is based on reputation and therefore they will not act opportunistic since that would create a bad name. However, from 2007 a decrease in listings at the AIM can be observed.[211] This is caused by the financial crisis that started that year and during this crisis, the market for reputation failed which was bad for the AIM.

4.4 Integration of securities regulation

While the financial services industry in Europe has been integrated, each country still has its own regulations. This lack of coordination has proven to be a serious problem since during the financial crisis, European authorities could not get a clear picture of the performance of complicated financial instruments like the credit-default swaps.[212] Furthermore, due to the fact that each Member State has its own regulations, some investors were able to bet against bank stocks while in other Member States such short selling was prohibited.[213] Mr. Maijoor, the Chairman of the European Securities and Markets Authority (ESMA), stated that it is

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[209] Ibid

[210] London Stock Exchange, 'AIM The most successful growth market in the world', 2008, available at http://www.londonstockexchange.com/NR/rdonlyres/3B5EDCF9-1E01-4B7C-A31A-95B7170675B9/0/LSEAIMBROCHURE_WEB.pdf

[211] Chart contained in slides Lecture 10 IBL I course

[212] M. Scott, 'In Europe, Securities Overseer Spreads Gospel of Streamlined Regulation' in *The New York Times* December 26, 2011

[213] Ibid

likely that the impact on the financial system could have been smaller if the European authorities had access to more information.[214] The ESMA was formed in the beginning of 2011 and its main task is to create one set of securities rules for the 27 Member States of the EU. Other tasks include monitoring and assessing the market in the area of its competence and fostering the protection of investors.[215] It forms part of a package that is meant to reform the European System of Financial Supervision (ESFS).[216] The other organizations that will have to monitor financial activities are the European Systemic Risk Board (ESRB), the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA). Together, these authorities have the task of overseeing systemic risk and ensuring more harmonized supervisory powers.[217]

This new structure will be an improvement for the EU since it addresses the problem of financial institutions operating across borders while remaining at the national level.[218] The new European system of financial supervisors will provide integration of the financial markets and especially the ESMA has an important role with the creation of one set of securities rules for all the Member States. Another important new regulation concerns the Credit Rating Agencies (CRAs); they are subordinated by the acceptance and supervision of the ESMA and by July 2014, all CRAs will be regulated by it.[219] The reason for this is that they had their own role in the financial crisis which has been discussed frequently: they had a strong influence on the development of the structured finance market since they used ratings based on arguable methodologies that lowered the perception of credit risk.[220]

Despite the benefits of the reform of the ESFS, there is also criticism. One of the main critics relates to the lack of enforcement powers.[221] Binding rules and decisions can be adopted by the authorities but it is not clarified what is understood as 'binding' when it comes to enforcement so this does not mean that the authority can act against a national financial market participant.[222] Another problem lies in the division of the tasks between the European Commission (EC) and the ESMA. The ESMA can only issue standards that are 'genuinely

[214] Ibid
[215] http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_general_framework/mi0071_en.htm
[216] Ibid
[217] L. Sasso and N. Kost de Sevres, 'The New European Financial Markets Legal Framework: A Real Improvement? An Analysis of Financial Law and Governance in European Capital Markets from a Micro and Macro Economic Perspective', *Capital Markets Law Journal*, April 13, 2011, p. 1
[218] Ibid, p. 4
[219] Ibid, p. 15
[220] Ibid
[221] Ibid, p. 27
[222] Ibid, p. 27

technical, where their development requires the expertise of supervisory experts.'[223] Technical shall not imply 'strategic decisions or policy choices.'[224] If it implies strategic decisions or policy choices, it is the EC's task. However, purely 'technical' standards and standards involving policy choices are not always easy to distinguish.[225] Other critics are heard in respect to the efficient functioning of the authorities; the coordination between them might not be optimal since they are all located in different European cities with the ESMA in Paris, the EBA in London and the EIOPA in Frankfurt.[226]

4.5 Conclusion

One of Europe's latest efforts is the integration of the financial markets by reforming the European System of Financial Supervision. The ESMA has an important role in this with one of its most significant tasks: creating one set of securities rules for the 27 Member States. This also contributes to the access to the single market. Furthermore, Europe recognizes the importance of SMEs in the EU economy since they are significant job creators: 85 % of all new jobs in the past 5 years are created by SMEs.[227] Europe has a focus on small companies and facilitates them in various ways. Small companies are also important for the IPO market; a high percentage of IPOs is performed by VC-backed firms and also a high percentage of the potential IPOs in the near future will be done by VC-backed companies.[228] By easing access to (VC) finance for small companies through improving framework conditions and making cross-border investment easier, Europe hopes this will stimulate the EU economy in general. However, in Europe the IPO markets are less liquid which makes an IPO riskier and trade sales seems to be the preferred exit route so it is not sure that the IPO market will come back to its usual strength. Moreover, it is the question if IPO will ever be the golden standard for VC again because there are other alternatives and preferences. More on this will be discussed in the next chapter.

[223] Recital 12 of the Omnibus Directive
[224] L. Sasso and N. Kost de Sevres, 'The New European Financial Markets Legal Framework: A Real Improvement? An Analysis of Financial Law and Governance in European Capital Markets from a Micro and Macro Economic Perspective', *Capital Markets Law Journal*, April 13, 2011, p. 29
[225] Ibid
[226] Ibid, p. 30
[227] According to a study carried out at the request of the EU Commission: *the SME Performance Review*
[228] W. Bessler and M. Seim, 'European Venture-backed IPOs: An empirical analysis', March 7, 2011, p. 2

Chapter 5 – The end of IPO as golden standard for VC?

Venture-backed companies are gradually becoming less interested in launching an IPO and having the status of a public company. This might be due to the downturn of the US and EU IPO market, but it could also be that innovative high-growth companies see in a listing event a greater cost than the benefits that they can take from it. The reason for this is that as a listed company, they are subject to periodical disclosure requirements and stricter regulations (particularly costly SOX requirements). Furthermore, retail investors have mostly a short-term view and are looking for financial returns quickly, in which these companies are not interested. The JOBS Act is intended to reduce the costs for emerging growth companies when going public. However, it is the question if this still does make sense considering the recent developments. Given the recent surging of private secondary markets for shares in private companies, such as SecondMarket and SharesPost, capital is gradually shifting from the public equity markets to the private equity markets. On those markets, the regulatory burden is not that heavy and companies can easily raise capital there from professional, sophisticated investors. How is the appearance of these new private equity markets going to affect the IPO markets? Does this mean that IPOs will never again be regarded as the golden standard for the VC market? It was already clear that VC funds more and more prefer trade sales. This has also to do with the fact that a VC fund cannot exit the portfolio company immediately after an IPO because of the lock-up period. The decline in IPOs has disrupted the traditional VC cycle.[229]

5.1 Changes in the VC cycle

The ‘traditional’ VC cycle has already been discussed in chapter 1. The VC fund invests in portfolio companies and exits through an IPO. When the company is able to do an IPO, the investors can exit to enjoy the gains of their investment and the entrepreneurs can reacquire control over the company. The part that flows back to the initial investors (limited partners in the VC fund) enables the start of new VC cycle.[230] IPOs are considered to be essential in order to have a sound VC market.[231] However, the number of IPOs has declined over the past years. Trade sales are becoming more popular compared to IPOs and one of the reasons for this, amongst other reasons like the regulatory burden that comes with an IPO as already discussed, is that a VC fund cannot exit immediately after an IPO. Lock-up periods prevent

[229] J.M. Mendoza and E.P.M. Vermeulen, ‘The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity’, *Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011*, May 3, 2011 p. 4
[230] Ibid, p. 1
[231] Ibid

this. During a certain period of time, usually 180 days after the first trading day, shareholders with a large portion of shares are not allowed to sell them. This prevents the market from being flooded with the shares; it aligns the incentives of the current and new owners during the first period of time that the company is public.[232] Trade sales, to the contrary, offer immediate liquidity and other advantages such as no costly disclosure requirements and no obligations to maintain board seats for the VC.[233] Thus, a trade sale can be seen as the easier way to exit and especially when the IPO market is down, VCs prefer this option. The dominance of trade sales has the effect that only the best performing companies can afford a listing; others will involve in a trade sale. The best ones that have the ability to grow quickly are able to do an IPO and this consequently leads to more confidence of investors in the IPOs of VC backed firms. [234] This seems to be a new equilibrium in the exit market.[235]

A lot has changed in the VC market. Due to the new equilibrium, there has been a decrease in the number of VC funds.[236] The behavior of investors changes because of the increased time to liquidity and a high expected return rate: investments are made in fewer, but higher quality funds.[237] Because of the longer period between seed financing and exit (8,6 years in 2008), VCs are likely to invest more per company and rely on larger exits.[238] VC funds have become more risk averse: they are investing in less risky businesses and also at a later stage. Because of the fact that IPO as an exit becomes less likely, VCs are tended to avoid investments in capital-intensive and longer-to-maturity start-ups.[239] It seems that VC funds are now more acting as private equity investors and this disrupts the VC cycle as a whole.

5.1.1 Gaps

Because of the changed behavior of investors and VC funds, certain gaps have appeared in the VC cycle: gaps in the seed and early years of a firm's development and a liquidity gap.[240] The first gap is caused by the fact that VCs enter in a later stage because that is less risky and because it takes much longer now to raise a fund. New categories such as super-angels have

[232] E. Ofek, 'The IPO Lock-Up Period: Implications for Market Efficiency and Downward Sloping Demand Curves', *NYU Working Paper No. FIN-99-054*, January 2000, p. 5
[233] J.M. Mendoza and E.P.M. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', *Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011*, May 3, 2011 p. 2
[234] Ibid, p. 4
[235] Ibid
[236] Ibid, p. 8
[237] Ibid
[238] PriceWaterhouseCoopers, 'The exit slowdown and new venture capital landscape', 2008, p. 21
[239] Ibid, p. 27
[240] J.M. Mendoza and E.P.M. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', *Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011*, May 3, 2011 p. 10

filled in this gap in the early stage.[241] The JOBS Act could also open a door for a new category of investors in this early stage. It makes crowdfunding a legal option for entrepreneurs by removing the SEC restrictions that prevented this before.[242] Crowdfunding could play a complementing role to VC in the very early stages of the VC cycle. Section 101 of the JOBS Act directly addresses the problem of a funding gap in the early-mid stages by introducing the emerging growth company. It creates the possibility to list under favorable requirements for this new category of issuer: the emerging growth company that has already been discussed in chapter 2. By making it possible for small companies to do an IPO at an earlier stage in their life, the funding gap in the early and mid stages could also be filled in by public equity.

The liquidity gap is caused by the long exits horizons; investors (which can include employees through stock option plans, VCs, angels, corporations) want to exit but they have to wait long. Often the different types of investors have different exit strategy preferences and it is difficult to align these interests.[243] Therefore, it is likely that they will not be that involved anymore in the business as they were before. This liquidity gap can discourage entrepreneurs and early stage investors.[244] Because of the extended exit horizon, it is difficult to provide incentives for the founders and key employees in a start up company.[245] Normally, when an exit through an IPO is foreseeable, the entrepreneur and the VC enter into an implicit contract concerning future control over the company.[246] With the possibility of an IPO in mind, the entrepreneur has something like a call option on control.[247] Therefore, it is important to have an IPO exit available; otherwise the entrepreneur does not have this incentive. But because of the extended exit horizon in the changed VC cycle, this incentive is weakened. The lack of liquidity options is therefore dangerous since it could discourage entrepreneurship.[248]

[241] Ibid p. 3
[242] Title III JOBS Act
[243] J.M. Mendoza and E.P.M. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', *Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011*, May 3, 2011 p. 3
[244] Ibid, p. 10
[245] Ibid, p. 12
[246] R.J. Gilson and B.S. Black, 'Does Venture Capital Require an Active Stock Market?', *Journal of Applied Corporate Finance,* Winter 1999, pp. 36-48, p. 13
[247] Ibid
[248] J.M. Mendoza and E.P.M. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', *Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011*, May 3, 2011 p. 13

5.1.2 Other players

VCs might step in later in the VC cycle now but also new players have emerged. Super angels now have taken up the role of a VC fund. Super angels are funds that are managed by very rich (mostly former entrepreneurs) people and they invest a lot of own money while also attracting other investors. The advantage of the involvement of super angels is that they usually have experience and strong personal networks[249] since they are often former entrepreneurs themselves. They use a different investment strategy than VC funds: they make a lot of small investments in seed or early stage companies.[250] Furthermore, their motivations are different from those of a VC fund. Of course they also want to make money but they have a broader set of motivations such as paying back the society since they are already successful and want to help a new generation of entrepreneurs. That has also the effect that they consider a wider range of investment in terms of sector and that they are willing to make smaller investments.[251] Super angels tend to have the preference of exiting their portfolio companies in four years or less so they are likely to sell the company to large corporations because of the liquidity gap. When this is done at the early stage, it could harm the innovative potential of the company.[252]

Corporations are also entering the game in terms of corporate venture capital. Corporate venture capital can be described as programs in established firms that make investments in entrepreneurial companies.[253] CVC is part of the 'open innovation' approach of many corporations to learn about and get access to technologies and ideas arising in small entrepreneurial firms.[254] Often, a 100 % subsidiary is established which has the mission to help grow the business of the parent company.[255] First, CVC units only invested in later rounds but now they are becoming more interested in investing at the same stage as VC funds or even earlier at the seed rounds. The reason for this is the pressure on corporations due to the 'open innovation' approach; they have to use their efforts to find the best innovations and

[249] K.E. Wilson, 'Financing High-Growth Firms: The Role of Angel Investors', *Working papers series,* December 22, 2011, p. 38
[250] J.M. Mendoza and E.P.M. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', *Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011*, May 3, 2011 p. 11
[251] K.E. Wilson, 'Financing High-Growth Firms: The Role of Angel Investors', *Working papers series,* December 22, 2011, p. 39
[252] J.M. Mendoza and E.P.M. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', *Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011*, May 3, 2011 p. 11
[253] Definition derived from: I. MacMillan, E. Roberts, V. Livada and A. Wang, 'Corporate Venture Capital (CVC) Seeking Innovation and Strategic Growth; Recent patterns in CVC mission, structure, and investment', *National Institute of Standards and Technology – US Department of Commerce*, June 2008, p. 1
[254] Ibid, p. 6
[255] Ibid

integrate them.[256] However, there is not really an incentive for the employees in the subsidiary that makes the investments since those people actually do the same work as venture capital fund managers, but they do not earn that much. Managers of a VC fund normally get a fixed fee plus 20 % carried interest while CVCs normally do not offer such performance fees. Therefore, talented people are often moving from CVCs to more profitable VC funds[257] since they have no incentive to undertake the same as a VC fund manager for a considerably lower fee in a CVC unit.

CVC partnering is becoming increasingly popular; corporations are not investing directly in startups then but in a VC fund while supporting the startup with advice and assistance.[258] It involves three parties: the corporation who puts itself forward as an attractive partner, the startup company and the VC fund. Advantages include the benefits a corporation enjoys because of the VC fund has its experienced fund managers, the VC fund can profit from an active corporate investor who may be helpful in selecting and supporting the development of promising startups, the possible exit opportunity for the VC fund when the corporation is interested in acquiring and of course to keep a window on emerging businesses and innovative technologies open.[259] Problems related to huge information asymmetries could arise since, for example, the corporation as a strategic investor would have more information on the internal management of the business. The corporation could behave opportunistically by stealing the idea and only using the startup for that purpose. When the corporation then has what it needed, it could let the startup just 'die' since the corporation would certainly win from the startup when it comes to legal actions. In fact, the corporation is stealing from the investors in such a situation. To prevent this opportunistic behavior, contractual provisions are needed. Covenants that are restrictive in nature then correspond to the uncertainty, information asymmetry and agency costs that are involved when a strategic investor participates.[260]

[256] J.M. Mendoza and E.P.M. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', *Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011*, May 3, 2011 p. 12
[257] J.A. McCahery, E.P.M. Vermeulen and A.M. Banks, 'Corporate Venture Capital: From Venturing to Partnering', p. 10 in: *The Oxford Handbook of Venture Capital*, D. Cumming (ed.), Oxford University Press 2012
[258] Ibid, p. 22
[259] Ibid, p. 23
[260] Ibid, p. 27

5.2 Private secondary markets

As already stated, the lack of liquidity options in the new VC cycle is dangerous since it could discourage entrepreneurship and innovation. Because of the extended horizon in the changed VC cycle, entrepreneurs are not incentivized anymore to undertake something. Although the gaps in the seed and early years of the firm's development could be filled in by for example angel investors, the liquidity gap remains a problem. The rise of the private secondary markets could offer a solution for this and may even be seen as essential in the new VC cycle.[261] Private secondary markets are platforms that bring together buyers and sellers of non-listed shares. These markets are lightly regulated compared to public exchanges because retail investors are not allowed to buy shares on it.

5.2.1 SecondMarket and SharesPost

SecondMarket and SharesPost are two well-known examples because of their involvement in trading Facebook shares prior to its IPO. In the 4 months before that IPO, 70 % of the transactions on SharesPost involved Facebook pre-IPO shares and on SecondMarket, half of all transactions were related to Facebook.[262] On private secondary markets, you have to be a professional investor to buy shares; most of the buyers are VC funds.[263] Its competitor SharesPost offers its members templates of purchase agreements that can be used on its online bulletin board marketplace.[264]

The securities that are dealt in SecondMarket are not subject to registration with the SEC because of the so-called Section 4(1 ½) exemption.[265] This exemption technically does not exist but in fact it is a Section 4(1) exemption informed by Section 4(2)'s distinction between public and private offerings.[266] Section 4(1) exempts transactions from Section 5, which imposes registration requirements. However, to qualify for an exemption under 4(1), one must not be an underwriter, issuer or dealer in the transaction. The definition of issuer is broad and includes control persons.[267] A control person may be an underwriter for the issuer

[261] J.M. Mendoza and E.P.M. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', *Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011*, May 3, 2011 p. 14 and 16
[262] J. Light, 'Facebook: What's next for secondary markets', *The Wall Street Journal's personal-finance blog*, June 7, 2012
[263] Ibid, p. 18
[264] Ibid, p. 19
[265] S.J Choi. and A.C. Pritchard, *Securities regulation: Cases and analysis (Second Edition)*, New York: Thomson/Foundation Press 2008, p. 660
[266] Ibid, p. 662
[267] Section 2(a)(11) '33 Act

when he resells with a 'view to' the 'distribution' of securities.[268] When this is the case, 4(1) is not available. Even if the control person is not an underwriter for the issuer, it can still be the case that a third party serves as the control person's underwriter (for example an intermediary) and this means that the control person still faces registration requirements under Section 5. Therefore, it is important that the intermediary facilitating the control person's shares will not be considered as an 'underwriter.'[269] This can be accomplished by means of 4(2); under this exemption, issuers are allowed to make private placements to investors who are able to 'fend for themselves' which means that they are sophisticated investors. Although it seems that a 4(2) exemption is only available for issuers, the same rationale also applies to control person resales to sophisticated investors.[270] The following reasoning lies underneath this: 'if the control person sells to an investor who is able to fend for himself, there is no 'distribution' within the meaning of Section 2(a)(11) and therefore no 'underwriter' in the control person's transaction.'[271]

Also Rule 144 and 144A play an important role in SecondMarket transactions. Rule 144 allows the public resale of restricted and control securities; it provides a safe harbor for resales from Section 5's registration requirements under certain conditions such as a holding period of one year.[272] Rule 144A is also very important since it makes it possible to sell huge amounts of securities through an investment bank to many qualified institutional buyers when Rule 144A is combined with an initial private placement under Section 4(2) or Rule 506.[273] It allows the initial buyer to resell as long as the ones to who he is selling are institutional investors. There are some requirements set by Rule 144A of which the most important one is that the offers and sales must be to a qualified institutional buyer (QIB). This is defined as an entity that in aggregate owns and invests on a discretionary basis $ 100 million or more in securities of companies unaffiliated with the QIB.[274]

5.2.2 Concerns about private secondary markets

Regulators are concerned about the increasing number of transactions on private secondary markets because of the lack of information about the companies whose stock is traded there.

[268] S.J Choi. and A.C. Pritchard, *Securities regulation: Cases and analysis (Second Edition)*, New York: Thomson/Foundation Press 2008, p. 657
[269] Ibid, p. 661
[270] Ibid
[271] Ibid, p. 662
[272] Ibid, p. 665
[273] Iid, p. 675
[274] Ibid, p. 676

One of the main concerns of the SEC is the lack of transparency in these markets.[275] Although the investors on these markets are no retail investors but sophisticated investors who can fend for themselves, the SEC may consider these markets too risky, even for them.[276] In January 2011, SecondMarket received an SEC inquiry about pooling investors for private company stock.[277] To avoid surpassing the 500 shareholder threshold,[278] Goldman Sachs created a SPV that was considered as one investor and made it possible for other investors to invest in that, thus having indirectly shares in Facebook. It could be seen as a way of circumventing the 500 shareholder threshold and thus registration before the SEC.[279] As also discussed in chapter 2, companies have various reasons to avoid this threshold. They may not be ready to go public, the costs of preparing the needed reports are high and it is not attractive for a company to be forced to reveal strategic information about its activities since competitors also have access to that information then.[280] However, such issues are not apparent anymore since the JOBS Act tackles this problem by increasing the threshold. Title V of the JOBS Act raises this threshold to 2000 shareholders and, more importantly for growing companies who are dependent on stock options to attract employees or have their shares traded on private secondary markets; it exempts employees and accredited investors from the count.

Disadvantages of private secondary markets also include the fact that key employees and founders can sell a large part of their shares. They can cash out at an early stage when the valuations are high but this also means that their incentives may not be as aligned as before: when they have a lower equity stake in the company, it is likely that they will not be that involved anymore to make the firm a success.[281] Often, those valuations can get very high since investors in the secondary private markets are attracted by the fact that these non-listed (high tech) companies can get very large before the IPO or trade sale so they hope to have a share in 'the next big thing.' This could create bubbles in the shares traded on these venues. Although the investors on private secondary markets are not retail investors, they still may not fully understand everything about fast growing startups in terms of their operation and development.[282] Therefore, the stock on the private secondary market may be overvalued at exit time. An example of this is Facebook; investors who bought pre-IPO shares hoped to

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[275] R.M. Bergen and S.J. Chen, 'Regulating secondary markets in the Facebook era', *Westlaw news and insight*, January 28, 2011
[276] Ibid
[277] Ibid
[278] Under the 'old' Section 12(g) of the '34 Act (before the JOBS Act), a company becomes an 'Exchange Act reporting company' when it has over 500 shareholders and more than $ 10 million in assets
[279] S.M. Davidoff, 'Facebook and the 500-person threshold', *Dealbook*, January 3, 2011
[280] J.M. Mendoza and E.P.M. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', *Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011*, May 3, 2011 p. 24
[281] Ibid
[282] Ibid

cash since the valuation on the private secondary market was very high, especially when it was announced that it would go public soon. But instead, they lost money: Facebook's shares went public at $ 38 but the share price already dropped to $ 27 at the same day.[283]

Early in 2011, the SEC started an inquiry into, amongst others, SecondMarket. The SEC has conducted a year-long inquiry into the trading of pre-IPO shares of private companies and charges were brought against several parties. However, SecondMarket was not amongst them.[284] SharesPost was but they settled with the SEC. The problem was that SharesPost and its CEO were not registered as a broker-dealer when it started in 2009 with the facilitation of trades in private company shares.[285] SharesPost paid $ 80.000 to settle the case and its CEO himself paid $ 20.000.[286] Civil charges were brought against Frank Mazzola and his firms Felix Investments (which is a Wall Street broker-dealer that mainly traded in the shares of social network companies like Facebook, Twitter and LinkedIn before they became public) and Facie Libre (which means *'face book'* in Latin). The firms created two funds to buy securities of Facebook and other tech companies. The SEC alleges that Mazzola and his firms engaged in improper self-dealing; they earned secret commissions above the 5 % that was disclosed in the offering materials that accompanied the acquisition of Facebook shares.[287] Therefore, the prices paid by investors for Facebook stock were too high because Mazzola and his firms had no incentive at all to negotiate a lower price for the fund investors. Furthermore, Facie Libre interests were sold despite the knowledge that the funds did not contain ownership of Facebook shares whereas the name of the fund does suggest otherwise. False statements were also made to investors in other funds that Mazzola and his firms created to invest in several pre-IPO companies. For example, they made false representations about Twitter's revenue to lure investors into their Twitter fund.[288] A Wells Notice (which means that the agency plans enforcement proceedings) was given from both the SEC and FINRA last year.[289] Now the SEC has charged Mazzola, Felix Investments and Facie Libre with violating Section 17(a) of the '33 Act and Section 10(b) of the '34 Act and Rule 10b-5(b) thereunder. Mazzola and Facie Libre are also charged with violating Section 206(4) of

[283] J. Light, 'Facebook: What's next for secondary markets', *The Wall Street Journal's personal-finance blog*, June 7, 2012
[284] B. Silbert (founder and CEO of SecondMarket), 'SecondMarket: Why wasn't Secondmarket part of the SharesPost/secondary market SEC action today?', March 16, 2012
[285] P. Lattman and E.M. Rusli, 'SEC close to bringing cases on 2 brokerage firms', *Dealbook*, March 12, 2012
[286] J. Pepitone, 'SEC crackdown ends Wild West days of private stock trades', *CNN Money*, March 15, 2012
[287] U.S. Securities and Exchange Commission, Litigation Release No. 22292/ March 14, 2012, *Securities and Exchange Commission v. Frank Mazzola et al., CV-12-1258 EDL* (U.S. District Court for the Northern District of California, filed March 14, 2012) on: http://www.sec.gov/litigation/litreleases/2012/lr22292.htm
[288] Ibid
[289] P. Lattman and E.M. Rusli, 'SEC close to bringing cases on 2 brokerage firms', *Dealbook*, March 12, 2012

the Investment Advisers Act of 1940 and Rule 206(4)-8 thereunder.[290] With this, the SEC has given a signal that it is watching the private secondary markets closely.

The problems that arise in private secondary markets can have the effect that the amount of trading will be reduced, which is bad for the VC industry since the secondary markets offer a solution to the liquidity gap. Problems related to the lack of transparency do not remain unnoticed by the secondary markets themselves. SharesPost introduced the 'SharesPost Index': this tracks changes in the value of each investment made on the platform.[291] SecondMarket has improved its platform, which now provides more information on private companies that was not accessible before. Participants are able to create a 'trusted network' in which they can include for example like-minded investors and companies that they can add to their watch list.[292]

Also a certain amount of regulatory intervention might be needed but this should be designed to support the further development of private secondary markets.[293] Mendoza and Vermeulen state that a segmented stock market (as in their example of the Tel Aviv Stock Exchange) with multiple tiers (with private secondary markets preferably as a springboard for higher segments) will contribute to the success of the VC industry since it integrates private secondary markets into the VC ecosystem.[294] Private secondary markets have become an essential component of the changed VC cycle since they offer a solution to the liquidity gap.

5.2.3 The future

Some question the future of private secondary markets since the once frozen IPO market seems to recover and had some major debuts[295] including Zynga, LinkedIn, Pandora, Groupon and recently, Facebook. However, the mishandling of Facebook's IPO[296] did not really contribute to more investor confidence. It is another thing added up to many that destroys confidence; we already had the 'flash crash' in May 2010 ($ 1 trillion in shareholder equity

[290] U.S. Securities and Exchange Commission, Litigation Release No. 22292/ March 14, 2012, *Securities and Exchange Commission v. Frank Mazzola et al., CV-12-1258 EDL* (U.S. District Court for the Northern District of California, filed March 14, 2012) on: http://www.sec.gov/litigation/litreleases/2012/lr22292.htm
[291] https://welcome.sharespost.com/sharespost-index
[292] A.J. Sherman, *Raising capital: Get the money you need to grow your business (Third Edition)*, AMACOM 2012, p. 128
[293] J.M. Mendoza and E.P.M. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', *Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011*, May 3, 2011 p. 25
[294] Ibid
[295] J. Pepitone, 'SEC crackdown ends Wild West days of private stock trades', *CNN Money*, March 15, 2012
[296] There were trading glitches on Nasdaq which resulted in a 30-minute delay of Facebook's debut on May 18, 2012 and after that, market makers failed to receive confirmations of their opening orders for 2 hours; this led to more than $ 100 million of losses. Source: Reuters, 'Facebook IPO mishandling hurt investor confidence: TD Ameritrade', June 7, 2012

was temporarily wiped out in minutes[297]) which seriously harmed the confidence of investors in the equity markets since trading is largely computer driven there.[298] When adding up the debt problems of the US and the financial crisis in Europe, it should come as no surprise that investors are hesitating.[299] Furthermore, it may seem that the IPO market has rebounded somehow but this does not change anything about the extended exit horizon in the VC cycle: it still takes much longer to go public and the private secondary markets are still a solution to that liquidity gap.

Others thought that the private secondary markets would not survive without Facebook: since Facebook accounted for the majority of trading on these markets (in the 4 months before the IPO, 70 % of the transactions on SharesPost involved Facebook pre-IPO shares and on SecondMarket, half of all transactions were related to Facebook[300]), they thought there would be a hole in the market once Facebook got public.[301] SecondMarket itself insist that private secondary markets will be a lasting companion to the public markets.[302] It considers Facebook as a 'catalytic event'; it made secondary trading visible for companies that first were not aware of it or did not understand it.[303] New players are also trying to set up similar initiatives as the well known SecondMarket and SharesPost. Liquidnet, for instance, profiles itself as the global institutional trading network:[304] it is a private market exclusively for institutional investors. Private companies that want to provide liquidity to their early investors or employees coordinate all the stock sales themselves and they have to disclose financial information.[305]

5.3 A substitution or a companion of IPO?

Could it also be that private secondary markets are going to substitute IPOs as exit and that the IPO will never again be regarded as the golden standard of the VC market? Due to the extended exit horizon caused by changes in the VC cycle, companies are likely to be more attracted to private secondary markets. While it is true that the private secondary markets offer a solution to the liquidity gap in the VC cycle, I do not think that these markets will substitute the IPO market as a whole. They are more a valuable supplement and could

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[297] Reuters, 'Facebook IPO mishandling hurt investor confidence: TD Ameritrade', June 7, 2012
[298] Ibid
[299] Ibid
[300] J. Light, 'Facebook: What's next for secondary markets', *The Wall Street Journal's personal-finance blog*, June 7, 2012
[301] M. Farrell, 'Facebook IPO shrinks private trading market', *CNN Money*, February 3, 2012
[302] J. Pepitone, 'SecondMarket: We'll survive without Facebook', *CNN Money*, February 16, 2012
[303] Ibid
[304] http://www.liquidnet.com/
[305] J. Light, 'Facebook: What's next for secondary markets', *The Wall Street Journal's personal-finance blog*, June 7, 2012

complete the exit options. The JOBS Act will also have positive effects on the private secondary markets despite the fact that it does make it easier for companies to go public. At the same time, it allows companies to stay private longer[306] so it will make the market much larger over time.[307] Companies are given more runway since they do not reach the 500 shareholders threshold that easily anymore and thus will not be forced to go public. In this way, they can remain private as long as they desire or need.

Private secondary markets could also serve very well as a springboard to the public markets. This can be illustrated by the GEM in Hong Kong. Although this is no private secondary market, it is a venue with lower listing requirements and it serves as a stepping-stone to the Main Board. Companies can 'practice' for a 'real' listing there and Hong Kong has shown us that it is successful. A segmented stock market that integrates private secondary markets into the VC ecosystem[308] may even be a better example: the pre-IPO segment would than be the private secondary markets, the 'higher' segment would be the IPO entry level (such as the TASE in Tel Aviv and the GEM in Hong Kong) and the highest level would than be the IPO. In this way, companies can get used to being listed in terms of requirements that get a step heavier when they go up the ladder.

The reasons why innovative high-growth companies became less interested in launching an IPO relate to the high regulatory burden and the extended exit horizon and gaps in the changed VC cycle caused a shift from public to private equity markets. Gaps at the early stage could be filled in by other parties such as angel investors but also by crowdfunding, which is now a legal option because of the JOBS Act. Crowdfunding could play a complementing role to VC in the very early stages of the VC cycle. Section 101 of the JOBS Act directly addresses the problem of a funding gap in the early-mid stages by introducing the emerging growth company. By making it possible for small companies to do an IPO at an earlier stage in their life, the funding gap in the early and mid stages could also be filled in by public equity. Because of the fact that the path to an IPO is eased in terms of less strict requirements for emerging growth companies, the problems related to high listing costs (many companies saw in a listing event a cost greater than the benefits) are being mitigated. The SOX requirements have been one of the most important factors behind the IPO

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[306] This is made possible by Title V of the JOBS Act: this raises the shareholder registration requirement threshold from 500 to 2000 shareholders and it exempts employees and accredited investors from the count.

[307] SharesPost CEO Greg Brogger in an interview: Katie Roof, 'SharesPost CEO announces SharesPost Index', *The Deal Pipeline*, April 16, 2012. Available at: http://www.thedeal.com/video/private-equity/sharespost-ceo-announces-share.php

[308] Such as the Tel Avive Stock Exchange which Mendoza and Vermeulen addressed in their research: J.M. Mendoza and E.P.M. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', *Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011*, May 3, 2011

slowdown[309] and Section 103 of the JOBS Act makes an important exemption for emerging growth companies: they are not required anymore to comply with Section 404(b) SOX. Private secondary markets offer a solution to the liquidity gap caused by the extended exit horizon. The JOBS Act also facilitates these markets by allowing companies to stay private longer.

To sum up, the JOBS Act makes an exit in the form of an IPO available for small companies thus making IPO more attractive again but it also gives companies the option to stay private longer. Therefore, the JOBS Act just broadens the options for emerging companies. They are given the choice; if the company considers itself to be ready for an IPO, it can go for that since the regulatory burden has decreased for emerging growth companies. At the same time, the access to private capital is facilitated by the JOBS Act. Crowdfunding has become a legal option and the shareholder limit has been raised from 500 to 2000 shareholders, excluding employees and accredited investors from the count. Therefore, a company can also decide to stay private longer and enjoy the benefits of the private secondary market. The question at the beginning of this chapter was if IPO will never be regarded as the golden standard for the VC market again and will be substituted by private secondary markets. I do not think that this will be the case; instead, private secondary markets could be considered as a welcome companion to IPO. They provide a useful solution to the liquidity gap in the changed VC cycle and they could serve as a springboard to the public market.

[309] PriceWaterhouseCoopers, 'The exit slowdown and new venture capital landscape', 2008, p. 12

Conclusion

The decline in number of IPOs in recent years has negative impacts on the venture capital industry since (the potential for) an exit through IPO is essential to a sound venture capital market.[310] This, in turn, is an essential condition for the flourishing of innovative, job-creating small and medium enterprises (SMEs). Efforts have been made to stimulate the access to capital and the result in the US is the Jumpstart Our Business Startups Act (JOBS Act). Some of the most significant provisions are the introduction of the emerging growth company (in Section 101); a category that is exempted from certain costly requirements that apply to 'normal' publicly listed companies, the crowdfunding provision (Title III) and the raise of the shareholder registration requirement from 500 to 2000 shareholders, exempting employees and accredited investors from the count (Title V). Some argue that this loosening of the rules makes fraud more likely to occur and ask themselves if House members have forgotten the lessons of Enron and other financial scandals. However, an important argument in favor of the JOBS Act is that is does not dismantle existing regulation.[311] The potential costs of bad behavior will be mitigated by the benefits of having more new companies established and able to go public.[312] Moreover, fraud in newly public companies is not a problem; history has shown that. The reason for this is the intense evaluation and examination process by lawyers, the SEC, accountants, underwriters and investors.[313] Besides, the rules that apply to publicly listed companies are designed for large-scale companies and do not fit the smaller startups at all: one size does not fit all so it seems logic to create a framework especially designed to the needs of smaller companies. Therefore, a comparison was made with foreign markets: how do they facilitate emerging companies in attracting (public) capital?

A comparison has been made with the Hong Kong IPO market since this has become a popular listing venue and it even ranked the world's largest IPO market in 2011 so it was useful to investigate what exactly contributes to this success. Is this due to the regulatory framework; is there legislation comparable with the JOBS act or are there other important factors? The Growth Enterprise Market (GEM; a 'buyers beware' market that facilitates emerging companies with lower financial requirements) is a significant factor; there has been a 'springboard' effect: in the depressed market of recent years, companies that are listing on

[310] R.J. Gilson and B.S. Black, 'Does Venture Capital Require an Active Stock Market?', *Journal of Applied Corporate Finance,* Winter 1999, pp. 36-48, p. 13
[311] W. Sahlman, 'How the NY Times got the JOBS Act wrong', March 15, 2012 on: http://www.xconomy.com/boston/2012/03/15/how-the-ny-times-got-the-jobs-act-wrong/
[312] Ibid
[313] Ibid

the GEM are favored by the rules that allow a transfer to the Main Board.[314] It seems that the success of the Hong Kong IPO market lies in the combination of China's economic growth, the key position in the region and the close cultural ties with the mainland. Favorable listing requirements of the GEM certainly support this when it comes to emerging companies. Resemblance to the JOBS Act could be made when it comes to easing the path to an IPO by lowering the (financial) requirements and the transitional nature, although the GEM is a special listing venue and a buyers beware market. This philosophy and the self-compliance culture by the listed issuers and sponsors can not be found back in the JOBS Act, especially not when it comes to the part of crowdfunding since that usually involves a large amount of retail investors. But the example of Hong Kong does show that there is a need of emerging companies to have regulations accommodated to their situation and despite the depressed market, the GEM is doing well.

Also the situation in Europe has been addressed in terms of efforts that have been made to overcome the problems related to the decreased confidence in European economies and companies and how emerging companies are facilitated in attracting capital. Europe recognizes the importance of small companies and their importance for the IPO market: a high percentage of IPOs is performed by VC-backed firms and also a high percentage of the potential IPOs in the near future will be done by VC-backed companies.[315] By easing access to (VC) finance for small companies through improving framework conditions and making cross-border investment easier, Europe hopes this will stimulate the EU economy in general. Therefore, one of Europe's latest efforts is the integration of the financial markets by reforming the European System of Financial Supervision. However, in Europe the IPO markets are less liquid which makes an IPO riskier. In Europe as well as globally, trade sales seems to be the preferred exit route so it is not sure that the IPO market will come back to its usual strength. Moreover, the question was posed if IPO will ever be the golden standard for VC again because there are other alternatives and preferences.

The rise of private secondary markets and recent changes in the VC cycle are important factors leading to this question. Because VC funds tend to invest at a later stage now, gaps have appeared in the early and mid stages of the VC cycle. Also a liquidity gap has appeared due to the extended exit horizon and private secondary markets offer a solution to this lack of liquidity options. The reasons why innovative, high-growth companies have become less interested in an IPO as exit relate to the high regulatory burden that comes with becoming and

[314] BDO Limited, 'GEM shines in a recession and depressed market? Possible rebound of the IPO market towards end of 2012?', press release of February 5, 2012
[315] W. Bessler and M. Seim, 'European Venture-backed IPOs: An empirical analysis', March 7, 2011, p. 2

staying a publicly listed company (SOX requirements are one of the most important factors behind the IPO slowdown[316]) and the extended exit horizon which now causes a shift from public to private equity markets such as SharesPost. The question was asked if this meant that private secondary markets will substitute IPOs as exit route and if IPO would never again be regarded as the golden standard of the VC market. Therefore, would the JOBS Act still make sense?

I think it does; the JOBS Act does ease the path to an IPO for emerging growth companies but it also facilitates companies on private secondary markets. It addresses the equity funding gap directly by facilitating emerging growth companies with lower requirements to go public; before the JOBS Act, these companies were not able to attract public capital in their early stages because of the high costs. The problems related to high listing costs (such as the SOX requirements; many companies saw in a listing event a cost greater than the benefits) are being mitigated by the exemptions. Gaps in the early stages could also be filled in by crowdfunding since that is a legal option because of the JOBS Act now; this could be a welcome addition to VC. At the same time, companies on private secondary markets are facilitated by Title V of the JOBS Act: this raises the shareholder registration requirement threshold from 500 to 2000 shareholders and it exempts employees and accredited investors from the count. Therefore, it allows companies to stay private longer. Private secondary markets can also serve very well as springboard to the public markets so that companies can get used to being ‘listed’. This springboard effect has also been observed in the Hong Kong market (from the GEM to the Main Board) although that does not involve a private secondary market but also a listing venue (which is intended as a stepping-stone; thus, of transitional nature) with lower financial requirements is involved. To sum up, private secondary markets could be considered as a welcome companion to IPO. They provide a useful solution to the liquidity gap in the changed VC cycle and they could serve as a springboard to the public market.

[316] PriceWaterhouseCoopers, ‘The exit slowdown and new venture capital landscape’, 2008, p. 12

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