American College of Governance Counsel
Third Annual Colloquium
Report of Proceedings[1]

On November 2-3, 2017, 54 Fellows of the American College of Governance Counsel met with noted guests to discuss the decline of the U.S. listed company. This Report summarizes the proceedings.

Overview of Program

The State of the U.S. IPO Market. Fireside Chat with Jay Clayton, Chairman, U.S. Securities and Exchange Commission. Moderated by John Olson.

The Decline of the U.S. Listed Company. Panel with Ken Bertsch, CEO, Council of Institutional Investors; Elisabeth D. de Fontenay, Duke Law; and Matt Levine, Bloomberg View. Moderated by Larry Sonsini and Joseph Grundfest.

Perspective on the IPO Process. Fireside Chat with Barry McCarthy, CFO, Spotify. Moderated by Larry Sonsini.

Governance Challenges for Late-Stage Private Companies. Case study workshop by Joseph Grundfest.

Executive Summary

- There is broad evidence of a decline in the number of listed companies. This decline has been accompanied by growth in the private sector.
- The decline can be traced to many factors. The role played by regulation is disputed. Fundamental macroeconomic shifts appear to be the primary cause.
- It is debatable whether the decline is positive, negative, or neutral.
- Given the fundamental macroeconomic drivers of the decline, there are limited ways to respond. Instead, counsel should realign their advice and practice to the new reality of increasingly robust private markets.

I. The Decline of the Listed Company

The decline of the listed company in the United States is well documented. Though the stock market continues to grow, the number of listed companies is half of what it was twenty years ago. Companies are both failing to list (i.e., choosing to remain

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private or be acquired) as well as delisting. As a result, today's listed companies are larger and older than ever.

Characteristics of U.S. Stock Market	1976	1996	2016
Number of publicly listed companies	4,796	7,322	3,671
Average market capitalization (millions 2016)	$620	$1,683	$6,893
Average age of a listed company (years)	10.9	12.2	18.4

E.g., Credit Suisse, *The Incredible Shrinking Universe of Stocks* (2017).

II. Factors Driving the Decline

A number of factors are responsible for the decline in listed companies.

<u>Nature of the Investor</u>

Public investors increasingly comprise large institutional investors. Their size demands that they invest in large amounts of stock to generate a meaningful return. There is accordingly weaker demand for small IPOs (as evidenced by lower earnings multiples).

Public investors are often focused on short term performance. A public company is vulnerable to short-termist shareholder activism. And institutional investors are hostile to dual-class (or non-voting) structures that might protect against harmful short-termism. This discourages firms from listing.

Public investors are typically disconnected from the business. Instead, they are focused on achieving alpha as represented by mathematical projections. As public markets homogenize with mature and stable companies, they become more predictable, and business-specific understanding is less important. In contrast, the typical private company investor is passionate and knowledgeable about the business, and brings a valuable network to bear. Such an investor is capable of making an informed investment in a volatile private firm. Managers stay private in part to take advantage of the value added by the private investor and avoid the disconnected public investors.

Private investors are aligned with managers. In addition to understanding the business, they typically stand side-by-side with management to help build the business. Moreover, they have access to relevant information not available to public company boards of directors, such as budgeting and forecasting. In contrast, public investors are fragmented, often lack understanding about the business, seek to wrest control from the managers, and are not invested for the long term. However, some note that venture capitalists and private equity investors may be more demanding and controlling than institutional investors.

Regulatory Landscape

Public markets have been burdened with regulation and disclosure requirements (i.e., Sarbanes-Oxley ("SOX"), Regulation FD). Regulators use inefficient information technology processes which further burden listed companies. Private companies gain valuable competitive information from public company disclosure without bearing any cost. Public companies are also subject to shareholder proposals, though some note that such proposals are received only by a small percentage of listed companies, and the possibility of receiving a proposal would not deter a company from listing.

More important, public markets are governed by an outdated regulatory regime. The 80-year-old laws around disclosure, structure, and governance assume that the investor is an individual. But the modern reality is that most investors are sophisticated fund managers and powerful family offices. These investors do not need the same protections. Likewise, underpinning the securities regime is the notion of a so-called reasonable investor who cares about the business. Today's investors, however, are often guided by cold mathematics, and are disconnected from the business itself. Regulation should be revised to reflect these new realities.

By contrast, private markets have been de-regulated (i.e., the JOBS Act elimination of the prohibition against general solicitation and general advertising in Rule 506 and Rule 144A offerings).

These regulatory differences may bear some responsibility for the decline of the public markets and growth of the private markets. However, the consensus is that regulation impacts only at the margins, as companies will generally pursue the value-maximizing path irrespective of regulation. This view is supported by the fact that the (i) decline began before SOX and (ii) JOBS Act has not reversed the decline.

Capital Markets

Decimalization in 2001 increased volatility and trading costs, and decreased liquidity, making the public markets less attractive. The quarterly focus of the markets creates pressure to achieve short-term results at the expense of long-term value, further incenting managers to stay private.

Corporate Strategy

The need to rapidly expand in scale and scope is increasingly important for corporate success. Private markets are agile and can quickly provide significant funds to facilitate such expansion. Likewise, small companies are often bought by larger companies who will then drive such expansion. This favors private markets.

In addition, the longer product cycles required by modern disruptive technologies make the short-termist public markets less attractive. In contrast, private markets are aligned toward the long term, and focus on cash flow rather than earnings.

<u>Motivation to List</u>

Increasingly, companies list to obtain liquidity, not to fundraise for investment. Adequate funds can often be raised in private markets. For this reason, companies that list often hold the IPO funds in cash to enable employees to liquidate their shares. Indeed, some argue that employees should be freely permitted to sell their shares, as that would reduce the need for the IPO device. However, public markets would still be needed to facilitate an exit of a company too large to be acquired.

<u>Underwriting Market</u>

The Global Analyst Research Settlement in 2003 curbed "hot" IPOs influenced by research analysts. There has also been a decline in investment banks focused exclusively on the technology industry (i.e., Montgomery Securities). These changes have dampened the supply side of the IPO market.

<u>Fiscal policy</u>

Low-interest policies have fueled private markets. Investors chase yield and growth through, for example, (i) private equity leveraged buyouts and (ii) actively managed mutual fund investment in venture capital.

<u>Globalization</u>

The traditional U.S. model of public capital markets has been replicated in other countries. Companies can now choose (subject to certain limitations) to list where they anticipate the highest valuation. Investors choose to buy where they anticipate the highest return. Increasingly, that choice has led to locations outside the U.S. While U.S. listings have declined, non-U.S. listings have continued apace.

Some contend that the robust private market in the U.S. is the next generation of capital formation, one that is more efficient and sophisticated than public markets. They see the divergence between the U.S. and other markets as a positive development. Whether the decline in U.S. listings is negative, neutral, or positive is discussed more fully in Part III.

Robust Private Markets

Today's private markets are large, liquid, efficient, and inexpensive. Characteristics include: record levels of private equity dry powder and investment cash held by multinational corporations and sovereign wealth funds, the rise of the family office and pension fund in direct investment, availability of debt capital, and robust marketplaces for shares of private companies.

Perhaps the biggest catalyst of today's robust private markets is the shift by institutional investors to private companies. Large institutions like Fidelity and T. Rowe Price decided they were not getting appropriate allocations in public offerings. In search of better returns, they moved down-market into late-stage private companies. Others followed. As a result, private markets are awash with capital available to rapidly growing companies with a global market.

Beyond the flood of capital, private markets are more dynamic because they have become the centers of innovation within the corporate ecosystem.

In the 1990s, R&D was centered in large companies. For example, a biochemist with an idea for a new chemical compound would join a listed pharmaceutical company. The biochemist would earn patent royalties. R&D would thus occur within Big Pharma.

In contrast, today that same innovator would raise private venture capital and create a private company. R&D would occur within the private company. Then, when the product matures, the private company will be acquired by a listed pharmaceutical company which can rapidly scale, leverage across other products, and distribute. This shift is visible across technologies (e.g., Cisco, Facebook).

As a result of this shift, innovation is happening on the private side, while the listed company functions more as an administrator. This shift gives more power to the entrepreneur relative to the investor. And it further deepens the value and dynamism of private markets.

Size of Listed Companies

The growth in size of listed companies has allowed them to acquire smaller firms that would otherwise have listed. This further reduces the number of new listings.

IPO Alternatives

A combination of technological and regulatory change has opened alternative "IPO-lite" paths to capital formation. This diverts some firms away from traditional listings. Examples include: Regulation A Offering, Initial Coin Offering, Equity Crowdfunding, and Private Placements under Rule 506 of Regulation D.

Increased M&A Activity

Another driver of the decline is that many companies now prefer an exit through M&A over an IPO. M&A often yields a higher premium (e.g., AppDynamics was bought by Cisco days before its scheduled IPO at a 117% premium to the expected IPO price). It often offers a shorter time to liquidity and has no lockup. Because an M&A process often concludes sooner than an IPO process, there is less risk of a contingency occurring during the process, such as a downturn in the market, the broader economy, or the company's performance.

Few Benefits To Listing

Formerly, the main reason to list was access to capital. Companies were willing to provide disclosure for such access. But given today's robust private markets, there is less incentive to list.

III. Impact of the Decline

Whether the decline in U.S. listings is negative, neutral, or positive varies depending on perspective.

Negative

The federal government's position is that more public companies are needed to provide investment opportunities for retail investors and 401(k) managers. Though the overall public market is larger than ever, the lucrative hyper-growth stage increasingly occurs before listing. Likewise, though mutual funds are now investing in private companies—providing retail investors with access to those markets—such investments are typically done a later stage, after hyper-growth has occurred.

Some worry that public equities will become a Ponzi scheme as the steady influx of 401(k) investment inflates prices beyond fundamentals.

Some are concerned that as listings decline, there will be less information in the market, which could in turn hinder price discovery and valuations.

In contrast, private equity firms often transact with each other, without the benefit of public signals. Such firms might prefer the decline, as the opacity could heighten their advantage over other market participants.

Neutral

Large public pension funds and index fund managers are not troubled by the decline. They still have robust investment opportunities, both in the public markets and in late-stage companies in the private markets.

Positive

Companies typically prefer today's environment of cheap and abundant private capital without burdensome regulation and disclosure.

From a utilitarian perspective, diminished regulation arguably increases efficiency. The growth of regulation-lite private markets thus benefits society as a whole.

There is also a view that the decline is positive for the capital markets. That mature companies dominate the public markets reduces volatility for less sophisticated "Main Street" investors. It makes sense for sophisticated private investors to make risky bets in the private markets before opening companies to public investment.

IV. Responding to the Decline

One way to respond is through regulatory change. There are three possible paths:

(1) make it easier to go public (less disclosure; enabling founders to retain control; remove lockup; fix pricing mechanism which currently is a range, is overpriced in the short term and underpriced in the long term, and does not take into account aftermarket trading revenue not seen by investment banks; better research, i.e., through unbundling; no tax on dividends; broaden the JOBS Act (i.e., eliminate the $1 billion revenue cap)),

(2) make it harder to stay private (increase regulation of private companies), or

(3) broaden access to private markets (through intermediaries and crowdfunding, and by broadening the definition of accredited investor).

As stated, however, regulatory change is likely to have a marginal effect at best.

Another possibility would be to craft a tiered IPO system. Disclosure and regulatory requirements would increase with the size of the company. Similar models have been adopted in other countries.

Conclusion

Ultimately, we believe that the decline is here to stay. It is primarily the result of fundamental macroeconomic shifts, not regulatory changes. The robust private markets characterized above continue to gain strength. Accordingly, rather than focus on responding to the decline, governance counselors should re-align their advice and practice to this new reality, in which capital formation and corporate activity increasingly occur in the private sphere.