The Untold Story of Underwriting Compensation Regulation

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This Article examines the regulation of underwriting compensation by the Financial Industry Regulation Authority ("FINRA"). *Although the regulation dates back almost fifty years and impacts virtually every U.S. public offering of securities, its propriety has received zero attention from legal scholars. This Article fills the gap in the literature. In that regard, it provides a history and overview of the regulation and critiques its policy justifications. The Article finds the justifications deficient and the regulation's costs conceivably quite large. Consequently, it contends that the regulation should be abolished.*

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INTRODUCTION

Underwriting compensation, the amount charged by underwriters for selling a company's securities to the public, is currently regulated by the Financial Industry Regulatory Authority ("FINRA"), the quasi-governmental self-regulatory organization that oversees all securities firms doing business in the United States.[1] With limited exceptions, no public offering can go forward until FINRA has reviewed and cleared the proposed underwriting compensation.[2] In its review, FINRA applies an undisclosed formula, which factors in the size, risk, and type of offering to determine whether the proposed compensation is "fair and reasonable."[3] If FINRA determines it is not fair and reasonable, the underwriter must reduce its compensation or abandon the offering.

Underwriting compensation regulation dates back to the early 1960s when the National Association of Securities Dealers, Inc. ("NASD"), FINRA's predecessor, found that in some cases, underwriters had received unfair and unreasonable compensation.[4] The NASD determined that this was inconsistent with its requirement that underwriters operate their businesses in observance of "just and equitable principles of trade."[5] Thus, the NASD (and later FINRA), not market forces, would determine maximum underwriting compensation. Regulators have justified this intervention on the policy grounds of issuer and investor protection.[6]

While underwriting compensation regulation is almost half a century old and impacts virtually every U.S. public offering, its propriety has received zero attention from legal scholars. This Article fills the gap in the literature. In that regard, the Article provides a history and overview of the regulation and critiques its policy

[1] *See* FIN. INDUS. REGULATORY AUTH., FINRA MANUAL: FINRA RULES r. 5110, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6831 [hereinafter CORPORATE FINANCING RULE] (providing for FINRA oversight of underwriting compensation). Regarding the governmental status of FINRA, see Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151, 151-52 (2008).

[2] *See* CORPORATE FINANCING RULE, *supra* note 1, r. 5110(f)(1).

[3] *See infra* Part II.C.

[4] *See* Letter from Wallace H. Fulton, Exec. Dir., Bd. of Governors, Nat'l Ass'n of Sec. Dealers, Inc., to Members of the Nat'l Ass'n of Sec. Dealers, Inc. (Dec. 26, 1961) [hereinafter Fulton Letter], *in* AM. BAR ASS'N, SELECTED ARTICLES ON FEDERAL SECURITIES LAWS 74, 74 (1968).

[5] *See id.*

[6] *See infra* Part III.

justifications. It finds the justifications deficient and the regulation's costs conceivably quite large. Consequently, the Article argues that the regulation should be abolished, at least with respect to initial public offerings ("IPOs").

Part I describes the underwriting process and typical underwriting compensation structure for an IPO. Part II provides a brief history of the NASD, FINRA and underwriting compensation regulation, and an overview of the Corporate Financing Rule,[7] the core of the current regulatory scheme. Part III critiques the two justifications for underwriting compensation regulation. Part IV details the costs of the regulation: namely, how the Corporate Financing Rule has contributed to the recent decline in the number of smaller IPOs and explains why the decline is problematic for society. Part V argues that rather than fine tune the existing rule, at least partial abolishment of the rule is warranted.

I. THE IPO UNDERWRITING PROCESS

Underwriting is the process by which investment banking firms or underwriters raise capital for companies through the sale of securities to the public.[8] Most IPOs are underwritten on a "firm commitment" basis, meaning the company sells newly issued shares of common stock to a syndicate of underwriters who immediately resell the shares to the public.[9] Typically, the IPO process takes several months[10] and is overseen by the managing underwriter, the investment banking firm a company chooses to take it public.[11] Among other things, the

[7] CORPORATE FINANCING RULE, *supra* note 1, r. 5110.

[8] *See* Nat'l Ass'n of Sec. Dealers, Exchange Act Release No. 17,271, 21 SEC Docket 930 (Dec. 12, 1980).

[9] *See* LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 327 (3d ed. 1998); *see also* Shaw v. Digital Equip. Corp. 82 F.3d 1194, 1200 n.1 (1st Cir. 1996) (describing firm commitment underwritings). Less established companies conducting offerings are sometimes underwritten on a "best efforts" basis. In a best efforts underwriting, the underwriters sell securities to the public on behalf of an issuer in exchange for a sales commission. They do not buy the securities from the issuer for resale to the public. Hence, a best efforts deal involves less risk for an underwriter than a firm commitment deal because the underwriter does not assume the risk of a drop in the value of the securities between when they are priced and when they are sold to the public. *See* George G.C. Parker, *Investment Banking*, *in* HANDBOOK OF MODERN FINANCE 4-1, 4-17 (Dennis E. Logue ed., 2d ed. 1990).

[10] *See* CHARLES J. JOHNSON & JOSEPH MCLAUGHLIN, CORPORATE FINANCE AND THE SECURITIES LAWS 3-5 (4th ed., supp. 2009).

[11] *See* Parker, *supra* note 9, at 4-17. It is not uncommon for a deal to be co-managed, i.e., to have more than one investment banking firm serving as managing underwriter. In such an event, one firm will typically be designated as lead manager or

managing underwriter participates in drafting the SEC registration statement for the offering, conducts a due diligence investigation of the company,[12] puts together the underwriting syndicate, and manages the marketing of the deal to the public.[13]

As part of the marketing effort, the underwriters gather "indications of interest" from investors, which are statements from investors as to how many IPO shares they are interested in buying and the price they are willing to pay.[14] The managing underwriter records this information in a metaphorical "book" in a process colloquially known as "book-building."[15] Then, the managing underwriter works with the

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book-running manager. *See id.* at 4-17 to 4-18. A company typically selects a managing underwriter based on a number of factors including reputation, experience, industry expertise, and distribution capacity. *See id.* at 4-23 to 4-24; *see also* NASDAQ, GOING PUBLIC: A GUIDE FOR NORTH AMERICAN COMPANIES LISTING ON THE U.S. SECURITIES MARKETS 18 (Nicole Lew ed., 2005), *available at* http://www.nasdaq.com/about/listing_guide.stm [hereinafter GOING PUBLIC GUIDE]; Shane A. Corwin & Paul Schultz, *The Role of IPO Underwriting Syndicates: Pricing, Information Production, and Underwriter Competition*, 60 J. FIN. 443, 445 (2005).

[12] The due diligence investigation serves at least two purposes. First, it lays the foundation for a future due diligence defense argument if the underwriters are later sued under Section 11 of the Securities Act for material misstatements in, or omissions from, the registration statement. *See* William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L.J. 549, 565-601 (2006) (discussing due diligence defense in depth). Second, it protects the underwriters' reputational capital. By bringing an offering to the market, the underwriters implicitly certify the legitimacy of the offering to the marketplace. *See* John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1220-21 (1997); Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675, 711 (1999); *see also* Corwin & Schultz, *supra* note 11, at 449 (discussing syndicate members' provision of incremental certification). If it turns out that the certification was misplaced, the underwriters' reputational capital is impaired. *See* James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 953 (1996) (stating that "underwriters seek to maintain [their] reputational capital through careful screening of the potential issuers for misleading information disclosure and fraud"). Therefore, an underwriter will not proceed with a deal if the investigation uncovers major problems with the issuer.

[13] Marketing includes sales-force calls to investors to educate them about the company and set up meetings with senior management and a "road show" where the company's top management travels to key cities across the country making presentations to, and fielding questions from, potential investors. *See* GOING PUBLIC GUIDE, *supra* note 11, at 22.

[14] *See id.*; *see also* Credit Suisse Sec. LLC v. Billing, 551 U.S. 264, 268 (2007) (noting that "[a] group of underwriters will typically form a syndicate to help market the shares").

[15] *See Credit Suisse*, 551 U.S. at 268 (describing book-building process); MICHEL FLEURIET, INVESTMENT BANKING EXPLAINED: AN INSIDER'S GUIDE TO THE INDUSTRY 165

company to set the final size, timing, and pricing of the offering.[16] Thereafter, the company requests the SEC to declare the company's registration statement effective.[17] Once the registration statement is effective, the underwriters and other securities dealers begin making sales to investors, and the stock starts trading in the secondary market on whichever exchange the company has chosen to list its shares.[18] The company and managing underwriter typically hold a closing three days later, at which time the company receives the net proceeds from the offering.[19]

An issuer compensates the underwriters of its offering for the above services primarily through the "gross spread," the difference between the price the underwriters sell the securities to the public and the price they purchase them from the company.[20] Gross spread is expressed as a percentage discount of the offering price. For example, suppose the company and underwriters agree on a seven percent gross spread for a $60 million offering consisting of five million shares to be sold to the public at $12 per share. The underwriters would purchase the shares from the company for a seven percent discount or $11.16 per share. They would then resell the shares to the public at $12.00 per share, yielding a gross profit of $0.84 per share or $4.2 million in the aggregate. IPO gross spreads range from four to ten percent.[21] Underwriters generally charge a larger percentage the smaller the deal because the effort required by underwriters to complete an IPO does not decrease proportionally with a decrease in deal size.[22] The standard gross spread for IPOs in the $25 million to $100 million

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(2008); Mark Abrahamson et al., Why Don't U.S. Issuers Demand European Fees for IPOs? 2-3 (Oct. 28, 2009) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1515768 (describing book-building process).

[16] *See Credit Suisse*, 551 U.S. at 269; FLEURIET, *supra* note 15, at 165-66; GOING PUBLIC GUIDE, *supra* note 11, at 22. This assumes the marketing has gone well, otherwise, the managing underwriter may choose to abort the offering. *See* 1 HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK § 5:3 (2008-2009 ed. 2009).

[17] *See* William K. Sjostrom, Jr., *Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?*, 53 FLA. L. REV. 529, 539 (2001) [hereinafter Sjostrom, *Going Public*].

[18] *See id.* at 540.

[19] *See id.*; *see also* GOING PUBLIC GUIDE, *supra* note 11, at 22.

[20] LOSS & SELIGMAN, *supra* note 9, at 342.

[21] *See* U.S. GEN. ACCOUNTING OFFICE, SMALL BUSINESS: EFFORTS TO FACILITATE EQUITY CAPITAL FORMATION 23-24 (2000) [hereinafter GAO REPORT], *available at* http://www.gao.gov/archive/2000/gg00190.pdf.

[22] *See id.* at 24. The higher commission rate may also reflect a risk premium, i.e., small offerings are more risky so underwriters require additional compensation to undertake them. *See id.*

range is seven percent.[23] For many offerings, the gross spread is the sole direct compensation the underwriters receive. Underwriters of small offerings, however, often require additional forms of compensation from the company such as warrants to purchase company common stock and financial consulting fees.[24] It is also common for an issuer to reimburse the managing underwriter for its legal and other expenses incurred in connection with the offering.[25] The gross spread percentage and any other types of underwriting compensation are specified in the underwriting agreement negotiated between the issuer and managing underwriter.[26]

In addition to the gross spread, IPO underwriters often receive indirect compensation as a result of underpricing.[27] Underpricing refers to the fact that underwriters routinely set the IPO "price to public" at an amount considerably below the price at which the IPO shares change hands in the secondary market on the first day of trading.[28] Underpricing indirectly compensates the underwriters because it makes it easier for them to sell their share allotments, thereby reducing the underwriter's effort and risk.[29] Underwriters can also use underpriced shares to curry favor with important existing and potential clients of their firms.[30] A client that is allocated underpriced

[23] *See* Abrahamson et al., *supra* note 15, at 3.

[24] *See* GAO REPORT, *supra* note 21, at 24; Craig G. Dunbar, *The Use of Warrants as Underwriter Compensation in Initial Public Offerings*, 38 J. FIN. ECON. 59, 60 (1995).

[25] *See* GAO REPORT, *supra* note 21, at 24. For an overview of underwriting agreements, see 1 BLOOMENTHAL, *supra* note 16, § 10:10.

[26] *See* JOHNSON & MCLAUGHLIN, *supra* note 10, at 2-18 to 2-19.

[27] *See* TIM JENKINSON & ALEXANDER LJUNGQVIST, GOING PUBLIC 24 (2d ed. 2001); Jay R. Ritter, *Initial Public Offerings*, *in* HANDBOOK OF MODERN FINANCE D11-1, D11-19 to D11-20 (Dennis E. Logue & James K. Seward eds., 1999 ed. 1998).

[28] *See* JENKINSON & LJUNGQVIST, *supra* note 27, at 4. For a discussion of various theories of the new-issues underpricing phenomenon, see Ritter, *supra* note 27, at D11-4 to D11-9.

[29] *See* Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 734 (2005) ("[A]n underwriter reasonably could underprice an issue somewhat to ensure that the offering closes successfully, avoiding the risk of a failed offering."); Tim Loughran & Jay Ritter, *Why Has IPO Underpricing Changed Over Time*, FIN. MGMT., Autumn 2004, at 5, 7 ("Investment bankers find it less costly to market an IPO that is underpriced.").

[30] *See* Loughran & Ritter, *supra* note 29, at 7 (noting that underwriters receive quid pro quos from clients in return for allocating them underpriced IPOs); Simon Fung et al., Investment Banks' Repeated IPO Business Opportunities and IPO Underpricing 8 (July 7, 2007) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=998394 (noting that "investment bankers set offer prices low enough for their regular (institutional) investors' to profit from the purchase and sale of the stock in early trading").

IPO shares will have a paper profit the moment the shares begin trading in the secondary market. Then, the client can lock in the profit by selling the shares immediately thereafter, if the client so chooses.[31]

If underwriters also receive warrants as part of their compensation, they benefit more directly from underpricing. An underwriters' warrant gives its holder the right to buy a specified number of shares in a company at a specified price (i.e., the exercise price), typically within five years of the offering.[32] The exercise price is set at a percentage of the price to public (i.e., typically 120%). Because underpricing results in a lower price to public, it results in a lower warrant exercise price, making the warrant more valuable.[33]

Additionally, underpricing furnishes underwriters with a form of insurance against litigation risk.[34] Specifically, underwriters face potential civil liability under Section 11 of the Securities Act of 1933 for material misstatements in, or omissions from, the registration statements.[35] Successful plaintiffs under Section 11 are entitled to damages equal to the difference between the amount they paid for the security (*not exceeding the offering price*) and: (1) the value of the security at the time of suit, (2) the price at which they sold the security before the suit, or (3) the price at which they sold the security after the suit but before judgment, provided that this amount does not exceed the amount calculated under option (1).[36]

For example, suppose the managing underwriter prices an IPO at $15.00 per share, and the shares start trading at $25.00 per share. Later, investors discover that the registration statement omitted some material negative information causing the shares drop to $15.00 per share. The underwriters will not be on the hook for damages under Section 11 even though the registration statement was defective causing the stock to drop $10.00 because the stock did not drop below

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[31] A customer's immediate resale of an IPO allocation is known as "flipping." *See* Hurt, *supra* note 29, at 748. Although flipping is perfectly legal, underwriters take various steps to prevent many customers from flipping because it puts downward pressure on the aftermarket price of an IPO while the underwriters would prefer the price only rise. *See id.*

[32] *See* 1 BLOOMENTHAL, *supra* note 16, § 10:12.

[33] *See id.*

[34] *See* Michelle Lowry & Susan Shu, *Litigation Risk and IPO Underpricing*, 65 J. FIN. ECON. 309, 310 (2002) (theorizing that issuers and underwriters underprice IPO shares in part to insure against future liability).

[35] Securities Act of 1933, Pub. L. No. 73-22, § 11, 48 Stat. 74, 82 (codified at 15 U.S.C. § 77k (2006)). For an overview of Section 11, see 2 BLOOMENTHAL, *supra* note 16, at ch. 26, pt. III.

[36] 15 U.S.C. § 77k(e) (2006) (emphasis added).

the offering price. In essence, Section 11 damages are capped at the offering price and, therefore, the lower the offering price, the lower the potential damages (and the lower the probability of a suit being brought).

In addition to selling the IPO shares to the public, underwriters also provide post-offering market support for an issuer's stock to foster the development of a liquid trading market.[37] This support includes acting as market makers for the stock, purchasing shares for their own accounts, and issuing analyst reports and recommendations to develop investor interest.[38] While underwriters are not contractually required to provide this support, business concerns ensure that they do. Specifically, future IPO issuers will look at the level of support that an underwriter provided to its past IPO clients when choosing a managing underwriter.[39] Additionally, investors with whom an underwriter has placed IPO shares will expect the underwriter to support the market and, therefore, failure to do so will negatively impact client relationships and the underwriter's reputation.

II. HISTORY AND OVERVIEW OF THE CORPORATE FINANCING RULE

A. The NASD and FINRA

The brokerage industry founded the NASD in 1939, following passage of the Maloney Act.[40] Congress adopted the Maloney Act to increase oversight of over-the-counter ("OTC") brokers and dealers through self-regulation overseen by the SEC.[41] The thought behind this approach was "to unite the technical skill and experience of the industry with the strength and prestige of Government for the elimination of both illegal and unprofessional practices injurious alike to investors, the vast majority of brokers and dealers and the public

[37] *See* Corwin & Schultz, *supra* note 11, at 444 (discussing importance of underwriter aftermarket support); Laird H. Simons III, *Considerations in Selecting the Managing Underwriter(s) for an Initial Public Offering*, *in* HOW TO PREPARE AN INITIAL PUBLIC OFFERING 83, 96 (PLI Corp. Law & Practice Handbook Series 2004).

[38] *See* Fung et al., *supra* note 30, at 8; *see also* Michael T. Cliff & David J. Denis, *Do Initial Public Offering Firms Purchase Analyst Coverage With Underpricing*?, 59 J. FIN. 2871, 2871 (2004) (noting that investment bankers provide post-IPO services "such as price stabilization, market making, and analyst research coverage").

[39] *See* Cliff & Denis, *supra* note 38, at 2871-72.

[40] *See* NAT'L ASS'N OF SEC. DEALERS, INC., REPRINT OF THE MANUAL 109 (1967) (providing details on the founding of the NASD).

[41] *See* S. REP. NO. 75-1455, at 1 (1938); H.R. REP. NO. 75-2307, at 2 (1938).

generally."[42] The Maloney Act added Section 15A to the Securities Exchange Act of 1934 ("Exchange Act"),[43] which allows an association of brokers or dealers to register with the SEC as a "registered securities association."[44] Among other things, Section 15A requires the association to adopt rules applicable to its members "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest."[45] The SEC approved the NASD's application for registration as a national securities organization in August 1939.[46]

The Rules of Fair Practice were among the NASD's initial rules, which, in addition to proscribing various unfair practices by members, provided that "[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."[47] This rule would later become the basis for underwriting compensation regulation.[48] The NASD enforced its rules through examinations of its members and by adjudicating customer complaints.[49]

Originally, NASD membership was voluntary. Nonetheless, a majority of brokers and dealers joined.[50] In 1983, Congress amended the Exchange Act to require virtually all brokers and dealers operating in the United States to become members and, therefore, be subject to NASD regulation.[51]

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[42] George C. Mathews, Comm'r, Sec. & Exch. Comm'n, A Discussion of the Maloney Act Program 1 (Oct. 23, 1938).

[43] 15 U.S.C. §§ 78a-78nn (2006).

[44] Securities Exchange Act § 15A, 15 U.S.C. § 78o-3 (2006).

[45] 15 U.S.C. § 78o-3 (2006).

[46] Application by Nat'l Ass'n of Sec. Dealers, Inc., Exchange Act Release No. 2,211, 5 S.E.C. 627 (Aug. 7, 1939).

[47] Paul S. Grant, *The National Association of Securities Dealers: Its Origin and Operation*, 1942 WIS. L. REV. 597, 602 (1942).

[48] *See infra* text accompanying note 59.

[49] Grant, *supra* note 47, at 605-06.

[50] *See* Alan Lawhead, *Useful Limits to the Fifth Amendment: Examining the Benefits That Flow From a Private Regulator's Ability to Demand Answers to Its Questions During an Investigation*, 2009 COLUM. BUS. L. REV. 210, 217 (2009); *see also* Grant, *supra* note 47, at 599 (discussing firms' motives to join).

[51] *See* Act of June 6, 1983, Pub. L. No. 98-38, 97 Stat. 205; *see also* LOSS & SELIGMAN, *supra* note 9, at 2824. A broker or dealer whom (1) deals exclusively in commercial paper, bankers' acceptances, or commercial bills; (2) effects transactions solely on a national securities exchange of which it is a member; or (3) is a member of a national securities exchange, carries no customer accounts, and "has annual gross income derived from purchases and sales of securities otherwise than on a national

In July 2007, the NASD was consolidated with the member regulation, enforcement, and arbitration functions of the New York Stock Exchange ("NYSE") to create FINRA.[52] The purpose of the consolidation was to eliminate regulatory overlap between the NYSE and NASD (many securities firms were subject to regulation by both entities).[53] Today FINRA regulates roughly 4,750 securities firms and approximately 644,000 registered securities representatives.[54]

Regulation of FINRA members is pursuant to FINRA rules. FINRA is currently in the process of consolidating NASD and NYSE rules into a single rulebook.[55] The FINRA Board of Governors must first adopt any new or amended FINRA rule,[56] and then the SEC must approve it.[57] Thereafter, the SEC may abrogate, add to, or delete from a FINRA rule whenever it deems such action necessary or appropriate to conform to, or further the purposes of, the Exchange Act.[58]

B. Corporate Financing Rule History

In December of 1961, the NASD Board of Governors announced that a newly created Committee on Underwriting Arrangements would begin reviewing underwriting compensation for offerings by unseasoned companies "to determine whether the arrangements entered into by members in connection with the offerings are fair and

securities exchange of which it is a member in an amount no greater than $1,000" does not have to join FINRA. *See* Exchange Act § 15(b)(8), 15 U.S.C. § 78o(b)(8) (2006); Rule 15b9-1, 17 C.F.R. § 240.15b9-1(2005).

[52] *See About FINRA*, FINRA, http://www.finra.org/AboutFINRA/index.htm (last visited Feb. 10, 2010) [hereinafter *About FINRA*]. Technically, the NYSE transferred its member regulation, enforcement, and arbitration functions to the NASD, which then changed its name to FINRA. *See* Order Approving Proposed Rule Change to Amend the By-Laws of NASD, 72 Fed. Reg. 42, 169 (Aug. 1, 2007).

[53] *See* Christopher Cox, Chairman, Sec. & Exch. Comm'n, Statement at News Conference Announcing NYSE-NASD Regulatory Merger (Nov. 28, 2006), *available at* http://www.sec.gov/news/speech/2006/spch112806cc.htm; *see also* JOHNSON & MCLAUGHLIN, *supra* note 10, at 6-3.

[54] *See About FINRA*, *supra* note 52.

[55] *See FINRA Rules*, FINRA, http://www.finra.org/Industry/Regulation/FINRARules/ (last visited Feb. 10, 2010).

[56] *See* FIN. INDUS. REGULATORY AUTH., FINRA MANUAL: BY-LAWS OF THE CORPORATION, art. XI, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&elementid=4661. The Board of Governors is currently comprised of twenty-one individuals including financial industry executives, academics, and public servants. *See FINRA Board of Governors*, FINRA, http://www.finra.org/AboutFINRA/Leadership/P009756 (last visited Oct. 26, 2010).

[57] *See* Securities Exchange Act § 19(b)(1), 15 U.S.C. § 78s(b)(1) (2006).

[58] *Id.* § 19(c).

consistent with just and equitable principles of trade . . . ."[59] This action stemmed from an NASD study of prospectuses and offering circulars, which found that in some cases, underwriters had received "unfair and unreasonable" compensation.[60] Shortly thereafter, the Committee on Underwriting Arrangements issued an interpretation specifying factors it would take into account when reviewing compensation.[61] Among the factors listed were the size of the offering, the type of underwriting, and the type of securities offered.[62]

The NASD refined and updated the interpretation over the ensuing years "for the purpose of keeping it current with changing conditions."[63] In 1992, the interpretation was replaced in its entirety with the Corporate Financing Rule, a new Rule of Fair Practice added to Article III of the NASD Manual.[64] In 1996, the Corporate Financing Rule became Rule 2710 of the NASD's Conduct Rules, in connection with a reorganization of the NASD Manual.[65] In 2003, the SEC approved extensive amendments to the Corporate Financing Rule designed to "modernize and simplify the Rule."[66] Finally, in September 2008, FINRA's consolidation of NASD and NYSE rules into the FINRA rulebook led to the renumbering of the Corporate Financing Rule as FINRA Rule 5110.[67]

C. Corporate Financing Rule Overview

The Corporate Financing Rule prohibits FINRA members from participating in any public offering in which the underwriting compensation is unfair or unreasonable.[68] Under the Rule, the

[59] *See* Fulton Letter, *supra* note 4, at 74.

[60] *Id.*

[61] *See* NAT'L ASS'N OF SEC. DEALERS, INC., *supra* note 40, at 2021.

[62] *See id.*

[63] Nat'l Ass'n of Sec. Dealers, Notice to Members Regarding Amendments to the Interpretation of the Board of Governors With Respect to Review of Corporate Financing (Dec. 16, 1970).

[64] *See* Order Approving Proposed Rule Change Relating to Codification of the Corporate Financing Interpretation, Exchange Act Release No. 30,587, 51 SEC Docket 314 (Apr. 15, 1992).

[65] *See* JOHNSON & MCLAUGHLIN, *supra* note 10, at 6-8 to 6-9.

[66] *See* Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendments Nos. 6, 7, 8, 9, and 10, Exchange Act Release No. 48,989, 81 SEC Docket 2984 (Dec. 23, 2003).

[67] *See* Order Approving the Proposed Rule Change to Adopt FINRA Rules 5110, 5190 and 6470 in the Consolidated FINRA Rulebook, Exchange Act Release No. 58,514, 94 SEC Docket 165 (Sept. 11, 2008).

[68] CORPORATE FINANCING RULE, *supra* note 1, r. 5110(c).

managing underwriter is generally required to file details regarding proposed underwriting compensation, as well as the proposed underwriting agreement and current version of the registration statement, with FINRA.[69] Proposed compensation consists of all "items of value received or to be received by the underwriter . . . in connection with or related to the distribution of the public offering."[70] Such "items of value" include the following:

- Underwriters' discount or commission;[71]
- underwriters' or related persons' expense reimbursement;[72]
- underwriters' counsel fees and expenses (except for "blue sky fees" reimbursements);[73]
- finder's fees;[74]
- wholesaler fees;[75]
- financial consulting and advisory fees;[76]
- stock, options, warrants, or other equity securities received: (a) for acting as a private placement agent for the issuer; (b) for providing or arranging a loan, credit facility, merger or acquisition services, or other services for the issuer; (c) as an investment in an issuer private placement; or (d) at the time of the public offering;[77]
- special sales incentive items;[78]
- any right of first refusal to underwrite or participate in any future financing of the issuer (to be valued at one percent of

[69] *Id.* r. 5110(c)(3)(A). Note that a few types of public offerings, for example short form shelf offerings, are exempt from the filing but still must otherwise comply with the Rule. *See id.* r. 5110(b)(7).

[70] *Id.* r. 5110(c)(2)(B).

[71] *Id.* r. 5110(c)(3)(A)(i).

[72] *Id.* r. 5110(c)(3)(A)(ii).

[73] *Id.* r. 5110(c)(3)(A)(iii).

[74] *Id.* r. 5110(c)(3)(A)(iv).

[75] *Id.* r. 5110(c)(3)(A)(v).

[76] *Id.* r. 5110(c)(3)(A)(vi).

[77] *Id.* r. 5110(c)(3)(A)(vii).

[78] *Id.* r. 5110(c)(3)(A)(viii).

the offering proceeds or the waiver fee, if any, agreed to by the issuer and underwriter);[79]

- compensation for serving as an advisor to the issuer's board of directors in excess of what directors receive;[80]
- compensation to be received by the underwriter and related persons as a result of the exercise or conversion within twelve months following the effective date of the offering of warrants, options, convertible securities, or similar securities distributed as part of the public offering;[81]
- fees of a qualified independent underwriter;[82] and
- compensation paid to a FINRA member during the six months prior to the filing of the registration statement for the current public offering for a proposed public offering that was not completed, unless the member will not be participating in the current public offering.[83]

Obviously, underwriting compensation is defined broadly given that items of value go well beyond fees related directly to the offering. Additionally, items of value received in connection with an offering by "related persons" are also considered underwriting compensation.[84] "Related persons" include all broker-dealers (and their affiliates, associated persons, and family members) participating essentially in any capacity in the proposed public offering, plus underwriters' counsel, finders, and consultants.[85] The broadness of the definition is

[79] *Id.* r. 5110(c)(3)(A)(ix).

[80] *Id.* r. 5110(c)(3)(A)(x).

[81] *Id.* r. 5110(c)(3)(A)(xi).

[82] *Id.* r. 5110(c)(3)(A)(xii).

[83] *Id.* r. 5110(c)(3)(A)(xiii).

[84] *Id.* r. 5110(c)(2)(B) (specifying that underwriting compensation includes items of value received or to be received by underwriter or related person).

[85] *See id.* r. 5110(a)(4) (defining "participating members" as "[a]ny FINRA member that is participating in a public offering, any associated person of the member, any members of their immediate family, and any affiliate of the member"); *id.* r. 5110(a)(5) (defining "participation or participating in a public offering" as "[p]articipation in the preparation of the offering or other documents, participation in the distribution of the offering on an underwritten, non-underwritten, or any other basis, furnishing of customer and/or broker lists for solicitation, or participation in any advisory or consulting capacity to the issuer related to the offering . . ."); *id.* r. 5110(a)(6) (defining "underwriter and related persons" as "underwriter's counsel, financial consultants and advisors, finders, any participating member, and any other persons related to any participating member").

presumably to thwart underwriters from easily circumventing the spirit of the Rule through creative compensation schemes or by redirecting fees to related parties.[86]

After receiving the required information and documents from the managing underwriter, FINRA tallies all the items of value and advises the managing underwriter whether, in its opinion, the proposed compensation is unfair and unreasonable.[87] If FINRA determines that it is, typically the managing underwriter and issuer reduce the compensation package to the point where FINRA signs off on it.[88] Otherwise, the managing underwriter calls off the offering.[89]

FINRA uses a multifactor formula to determine unfairness or unreasonableness, but the specifics have never been publicly disclosed out of concern that doing so "would tend to encourage members to charge issuers the maximum compensation allowed . . . ."[90] The Rule does, however, indicate that FINRA takes into account the dollar size of the offering, type of underwriting (i.e., firm commitment or best

[86] Note that in recognition of the increasing breadth of financing activities and services provided by investment banking firms, the Rule specifically excludes from underwriting compensation items of value received by an underwriter in connection with certain loans and private placements. *See id.* r. 5110(d)(5).

[87] *Id.* r. 5110(b)(4)(B)(ii). A 1998 NASD Notice to Members described the underwriting compensation review process as follows:

> NASD Regulation's Corporate Financing Department (Department) has direct responsibility for the review of underwriting compensation. The Department reviews public offerings before their effective dates and aggregates all items of value proposed to be received by underwriters and related persons. Total compensation is then reviewed and a determination is made as to whether the compensation is fair and reasonable.

Nat'l Ass'n of Sec. Dealers, Notice to Members 98-88 (1998).

[88] CORPORATE FINANCING RULE, *supra* note 1, r. 5110(b)(4)(B)(ii) (providing that "[i]f FINRA's opinion states that the proposed underwriting and other terms and arrangements are unfair and unreasonable, the member may file modifications to the proposed underwriting and other terms and arrangements for further review").

[89] For all practical purposes, a public offering cannot go forward without FINRA signing off on compensation because underwriter participation would violate FINRA Rule 5110(c) and the SEC would refuse to declare the registration statement effective. *See* 17 C.F.R. § 230.461(b)(6) (1998) (allowing SEC to refuse to accelerate effectiveness of registration statement if "the amount of compensation to be allowed or paid to the underwriters . . . participating in the distribution, as described in the registration statement, if required to be reviewed by [FINRA], have been reviewed by [FINRA] and [FINRA] has not issued a statement expressing no objections to the compensation and other arrangements").

[90] Order Approving Proposed Rule Change Relating to Codification of the Corporate Financing Interpretation, Exchange Act Release No. 30,587, 51 SEC Docket 314 (Apr. 15, 1992).

efforts), and type of offering (i.e., initial or follow-on) in making its determination.[91] As explained in a 1992 NASD Notice to Members:

> In determining the maximum amount of compensation that is considered fair and reasonable, the NASD considers the size of the offering and the amount of risk assumed by the underwriter, which is determined by whether the offering is being underwritten on a firm commitment or best efforts basis and whether the offering is an initial or secondary offering. The maximum guideline amount generally will vary directly with the amount of risk assumed by the underwriter and inversely with the dollar amount of offering proceeds. Firm commitment offerings are permitted higher levels of compensation than best efforts offerings due to the risk involved in an underwriter purchasing the securities for resale versus simply utilizing its best efforts to place the securities for the issuer. In addition, a firm commitment initial public offering (IPO) is generally permitted higher compensation than a firm commitment secondary offering because the underwriter is dealing with an unseasoned issuer and is likely to incur higher costs in introducing the issuer to prospective underwriters and investors. The higher percentage levels of compensation permitted in smaller offerings recognizes that certain fixed costs are involved in any distribution, regardless of size.[92]

The same Notice to Members also included a table of "generally accepted levels of underwriting compensation" as a percentage of gross offering proceeds for firm commitment initial offerings, firm commitment secondary offerings, and best efforts offerings filed with the NASD during 1991.[93] For firm commitment IPOs, the percentage

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[91] *See* CORPORATE FINANCING RULE, *supra* note 1, r. 5110(c)(2)(D).

[92] Nat'l Ass'n of Sec. Dealers, Notice to Members 92-53 (1992).

[93] *See id.* As the Notice to Members explains:

> To predict levels of underwriting compensation accurately, the [NASD Corporate Finance] Department analyzed the amount of compensation received, as disclosed in the final offering document or prospectus, for 874 corporate equity offerings filed with the Department during calendar year 1991. All items of underwriting compensation received by underwriters and related persons were considered, including: cash discounts or commissions; accountable and non-accountable expense reimbursements; warrants, options, cheap stock, and other securities and rights to acquire securities received by underwriters and related persons; finders fees paid for introducing the underwriter and the issuer; rights of first refusal; financial

ranged from 15.80% for offerings of $1 million or less to 6.89% for offerings of $50 million or more.[94] For firm commitment secondary offerings, the percentage ranged from 14.57% for offerings of $1 million or less to 5.00% for offerings of $50 million or more.[95] For best efforts offerings, the percentage ranged from 11.83% for offerings of $1 million or less to 5.57% for offerings of $50 million or more.[96]

III. JUSTIFICATIONS FOR REGULATION

A. Issuer Protection

The regulation of underwriting compensation began because the NASD concluded in 1961 that some underwriters had received compensation that was unfair and unreasonable.[97] The NASD, however, did not address why it believed this to be the case nor has it done so in the ensuing decades. The fact that underwriting compensation is set through negotiations between the managing underwriter and the issuer[98] implies that managing underwriters were somehow able to extract excessive compensation from issuers. As a repeat player in the public offering arena, a managing underwriter has more experience and perhaps more sophistication than an issuer, as public offerings are an infrequent occurrence for most issuers. It is doubtful, however, that these advantages would result in an issuer agreeing to pay excessive compensation. Typically, it is an issuer's chief executive officer and chief financial officer that negotiate compensation with the managing underwriter. Generally, both are successful businesspersons as demonstrated by the fact that their company is public or is in the process of going public. Additionally,

> consulting and advisory fees; and all other items of value received in connection with the offering.
>
> The offerings were organized into three categories: 402 firm commitment IPOs, 380 firm commitment secondary offerings, and 92 best efforts offerings. For each of the three categories, the staff performed a regression analysis to predict expected amounts of compensation for certain size offerings in each category.

Id.

[94] *See id.*

[95] *See id.*

[96] *See id.*

[97] *See supra* text accompanying note 60.

[98] *See* Nat'l Ass'n of Sec. Dealers, Notice to Members 98-88 (1998) ("The pricing of underwriting compensation, including the gross spread on offerings, is determined by the issuer and the underwriter through negotiation.").

both are likely experienced negotiators, and at the very least, the CFO will be highly sophisticated concerning financial matters. More importantly, the issuer will be represented by outside securities counsel who is a repeat player in the public offering arena and, therefore, provides the issuer with experience and sophistication on par with the managing underwriter.[99] Securities counsel will thus be able to advise the issuer as to the going market rate for underwriting compensation and flag any overreaching by the managing underwriter.

Underwriters do not even enjoy an informational advantage regarding what they have charged issuers in the past. SEC rules require a public offering prospectus to include disclosure concerning underwriting compensation.[100] The rules also require the underwriting agreement to be filed as an exhibit to the public offering registration statement.[101] These documents are freely accessible on the SEC's website.[102] Hence, detailed information about the amount and structure of underwriting compensation for past offerings by the managing underwriter are readily available to an issuer and its advisors.[103]

More importantly, senior executives have strong incentives to negotiate vigorously underwriting compensation. They almost universally hold equity stakes in the issuer that represent a large percentage of their personal net worth.[104] Thus, senior executives are

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[99] *See* 1 BLOOMENTHAL, *supra* note 16, at § 5:2.

[100] *See* Regulation S-K, 17 C.F.R. § 229.508 (1998) (requiring plan of distribution to include various information concerning underwriters of offering, including compensation); Form S-1, 17 C.F.R. § 239.11 (2005) (requiring prospectus to include "plan of distribution" section).

[101] *See* Regulation S-K, 17 C.F.R. § 229.601(a), (b)(1) (2009) (specifying that "each underwriting contract or agreement with a principal underwriter pursuant to which the securities being registered are to be distributed" must be filed with registration statement); 17 C.F.R. § 239.11 (2005) (requiring registration statement to include various exhibits).

[102] *See Search the Next-Generation EDGAR System*, SEC. & EXCH. COMM'N, http://www.sec.gov/edgar/searchedgar/webusers.htm (last visited Nov. 5, 2010).

[103] Underwriters do enjoy an informational advantage when it comes to private offerings because the fees they have charged issuers in the past typically remain private. Thus, information regarding the underwriter's compensation is not readily available to an issuer or its advisors. FINRA does not, however, review underwriting compensation for private offerings, even though they make up a sizable portion of securities offerings. *See* CORPORATE FINANCING RULE, *supra* note 1, r. 5110 (b)(8) (essentially exempting private placements from rule).

[104] *See* Richard A. Booth, *Going Public, Selling Stock, and Buying Liquidity*, 2 ENTREPRENEURIAL BUS. L.J. 649, 663 (2008); *see also* Malcolm P. Baker & Paul A. Gompers, Executive Ownership and Control in Newly Public Firms: The Role of Venture Capitalists 2 Nov. (1999) (unpublished manuscript), *available at*

highly motivated to avoid overpaying underwriters because of the negative signal high compensation sends to the marketplace.[105] Higher compensation signals that the managing underwriter views the issuer as more risky and, thus, has insisted on additional compensation as recompense for the additional risk. Investors will, therefore, discount the amount they would otherwise be willing to pay for the issuer's equity securities to reflect the additional risk signaled by the above-normal underwriting compensation.[106] This discount, in turn, means the equity stakes that management holds are worth less.

Labor-market reputation concerns also incentivize executives to avoid overpaying. In particular, an executive will want to preclude the signaling effect and actual overpayment because otherwise the executive's company will suffer a higher cost of capital. A higher cost of capital would subsequently harm the company's performance. Because company performance is attributed to its executives, their reputations would be diminished. This, in turn, would make the executives less attractive to employers looking to fill more lucrative or prestigious positions.[107]

Furthermore, if the concern is successful overreaching by underwriters when negotiating with issuers, FINRA should then also be regulating the price at which the securities are sold to the public. As previously stated, the price to the public for an IPO is set based on negotiations between the managing underwriter and issuer,[108] and here, the managing underwriter does have a distinct informational advantage. Specifically, the underwriter knows all the details of the book and the book-building process. The company does not disclose this information in the prospectus or registration statement,[109] and the managing underwriter does not share this information with the issuer.[110] Further, a significant component of underwriting

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http://papers.ssrn.com/sol3/papers.cfm?abstract_id=165173 ("Before an initial public offering (IPO), CEO ownership is 19 percent for venture capital-backed firms and 35 percent for nonventure capital-backed firms.").

[105] *See generally* Hayne E. Leland & David H. Pyle, *Informational Asymmetries, Financial Structure, and Financial Intermediation*, 32 J. FIN. 371 (1977) (describing role of signaling in financial markets).

[106] *See id.*

[107] *See* Jeremy C. Stein, *Agency, Information and Corporate Investment*, *in* HANDBOOK OF THE ECONOMICS OF FINANCE 111, 131 (2003).

[108] *See supra* text accompanying note 98.

[109] *See* Hurt, *supra* note 29, at 736.

[110] *See id.* (stating that "[o]nly the underwriter is aware of the price information that he is receiving").

compensation results from underpricing.[111] Thus, it seems absurd to regulate a litany of "items of value," but leave pricing unregulated. Underwriters are left free to skirt FINRA compensation caps simply by exercising their informational advantage to help shift compensation from the gross spread or other "items of value" to underpricing.

B. Investor Protection

The second justification in favor of underwriting compensation regulation is investor protection. The SEC stated, in approving the Corporate Financing Rule in 1992, that:

> By removing certain ambiguities and precisely outlining Association policy with regard to corporate financing matters, the NASD is providing its membership with a definitive guideline to follow when participating in a public offering of securities. This will allow the NASD to more efficiently detect and prevent unacceptable deviations from the Rule, *which ultimately furthers investor protection* by ensuring that the percentage of investment capital going toward underwriter compensation remains fair and reasonable.[112]

It is unclear why this "further investor protection" is needed. As mentioned above, senior executives have significant investments in the issuer and, therefore, have strong incentives to negotiate vigorously on compensation, which aligns with the interests of investors.[113] Furthermore, underwriting compensation is disclosed in the prospectus. Thus, an investor can choose not to make an investment if the investor feels "that the percentage of investment capital going toward underwriter compensation" is too high.[114] Regardless, the amount of underwriting compensation paid will be priced into the securities.[115] This means that the more compensation that the issuer pays out, the less the investor will be willing to pay, i.e., the lower the offering will be priced and the lower the securities will trade in the

[111] *See supra* text accompanying notes 27-36.

[112] Order Approving Proposed Rule Change Relating to Codification of the Corporate Financing Interpretation, Exchange Act Release No. 30,587, 51 SEC Docket 314 (Apr. 15, 1992) (emphasis added).

[113] *See supra* text accompanying note 104.

[114] *See supra* note 104 and accompanying text.

[115] *See* Basic Inc. v. Levinson, 485 U.S. 224, 241-42 (1988) ("[T]he price of a company's stock is determined by the available material information regarding the company and its business.").

aftermarket.[116] Hence, it is doubtful that the regulation does in fact provide "further investor protection" because investors are already fully protected against unfair and unreasonable underwriting compensation through the market mechanism. As discussed below, the regulation actually appears to harm private company investors because it makes it more difficult for many private companies to go public.[117] My suspicion is that the SEC was just paying lip service to investor protection because the Exchange Act requires it to do so when approving self-regulatory organization rules.[118]

IV. COSTS OF REGULATION

Given the long history of underwriting compensation regulation, does the lack of convincing justification matter? This Part argues it does indeed matter. The lack of a convincing justification calls into question what benefits the regulation provides. In fact, there are significant costs that arise because of the regulation. This Article posits that the regulation has prevented underwriters from increasing compensation in response to changes in the economic model for IPOs resulting in a steep decline in smaller IPOs.

Over the last two decades, a series of regulatory actions have profoundly impacted the economic model for IPOs. These actions include the adoption of decimalization (requiring exchanges to quote securities in one cent increments instead of fractions of a dollar[119]), order handling rules (requiring market makers to display publicly their most competitive quotes[120]), Regulation FD (prohibiting selective disclosure by companies to analysts[121]), and the global analyst research

[116] *See id.*

[117] *See infra* Part IV.

[118] *See* Securities Exchange Act § 15A(b)(6), 15 U.S.C. § 78o-3(b)(6) (2006) (requiring SEC to determine that NASD/FINRA rules "are designed . . . to protect investors," among other things); *see also* Order Approving Proposed Rule Change Relating to Codification of the Corporate Financing Interpretation, Exchange Act Release No. 30,587, 51 SEC Docket 314 (Apr. 15, 1992) (providing that "the Commission finds that the Corporate Financing Rule is consistent with Section 15A(b)(6) of the [Exchange] Act in that it is designed to prevent fraudulent and manipulative acts and practices, and designed to protect investors and the public interest").

[119] *See* Order to Submit a Decimalization Implementation, Exchange Act Release No. 42,360, 71 SEC Docket 1274 (Jan. 28, 2000).

[120] *See* Order Execution Obligations, Exchange Act Release No. 37,619, 62 SEC Docket 1795 (Aug. 29, 1996).

[121] *See* Selective Disclosure and Insider Trading, Exchange Act Release No. 43,154, 73 SEC Docket 3 (Aug. 15, 2000).

settlement (requiring financial firms to separate research and investment banking[122]).[123] These developments negatively impact the post-offering market support activities that underwriters provide.

For instance, decimalization and the order handling rules decrease the profitability of underwriter market making. Regulation FD and the global analyst research settlement increase the cost of providing post-IPO research. Underwriter compensation regulation, however, prevents underwriters from recouping these lost profits or increased costs through charging issuers more for underwriting IPOs. This Article theorizes that as a result, smaller IPOs (i.e., those raising proceeds of less than $50 million) are no longer profitable for underwriters and, therefore, underwriters no longer take them on. A recent study of the IPO market provides support for this theory. The study found that "[f]rom 1991 to 1997 nearly 80% of IPOs were smaller than $50 million. By 2000 the number of sub-$50 million IPOs had declined to only 20% of the market."[124] The study observed that by 2009 the smaller IPOs had all but disappeared.[125]

This disappearance is troublesome because smaller IPOs represent the preferred route to equity capital and share liquidity for emerging companies, the primary drivers of the U.S. economy.[126]

Emerging companies have traditionally followed a standard path to fund their businesses. Typically, an emerging company raises equity capital through the sale of stock to angel investors and venture capitalists.[127] It then uses this funding to develop and commercialize its business concept, at which point it goes public through an IPO.[128] Going public provides the company with a large infusion of additional

[122] *See* Sec. & Exch. Comm'n, Statement Regarding Global Settlement Related to Analyst Conflicts of Interest (Apr. 28, 2003), http://www.sec.gov/news/speech/spch042803com.htm.

[123] *See* DAVID WEILD & EDWARD KIM, MARKET STRUCTURE IS CAUSING THE IPO CRISIS 8-10 (2009), *available at* http://www.grantthornton.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/Files/IPO%20crisis%20-%20Sep%202009%20-%20FINAL.pdf.

[124] *Id.* at 8 ex. 5.

[125] *Id.* at 7.

[126] Jeffrey E. Sohl, *The Early-Stage Equity Market in the USA*, 1 VENTURE CAPITAL INT'L J. ENTREPRENEURIAL FIN. 101, 105 (1999); *see also* Ronald L. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1068 (2003) ("Beyond representing an important engine of macroeconomic growth and job creation, [emerging companies] have been a major force in commercializing cutting-edge science . . . .").

[127] *See* William K. Sjostrom, Jr., *Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. U. L. REV. 1, 5-7 (2004).

[128] *See id.*

equity capital it can use to ramp up production, marketing, and sales.[129]

More importantly, an IPO results in a public market for a company's shares and, therefore, share liquidity.[130] Share liquidity is particularly important to venture capitalists because it allows them to cash out or exit their investments.[131] In fact, the venture capital business model of providing short-term funding to start-up companies depends on exit.[132] Exiting a company once it goes public allows a venture capitalist to recycle into new ventures the financial and nonfinancial support[133] it provided the company to get it to its IPO.[134]

With the disappearance of smaller IPOs, venture capitalists have had to shift their primary portfolio company exit strategy from IPOs to sales.[135] This is problematic. As explained in a recent white paper by Grant Thornton LLP:

> Gone are the days when most venture capitalists would willingly pioneer new industries and technologies (e.g., semiconductors, computers and biotechnology) that have no obvious outlet other than the IPO market. Today, the first question most venture capitalists ask of a potential portfolio investment is, "Who are the natural strategic buyers for your company or idea?" If the answer is "no one," as it might have been in 1983 when Genentech was the first biotech company to go public, the likelihood is that the Genentechs of our world might never be funded.[136]

Furthermore, the shrinking IPO market may also be discouraging potential entrepreneurs from starting new companies. Most emerging companies require venture capital financing in their early years of existence. In order to get this financing, an entrepreneur will have to

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[129] *See* Credit Suisse Sec. LLC v. Billing, 551 U.S. 264, 276 (2007) ("The IPO process supports new firms that seek to raise capital.").

[130] Shares are considered liquid if they can quickly and easily be converted into cash at a low transaction cost. *See* Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 321 (2000).

[131] *See* Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 252 (1998).

[132] *See* D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 316 (2005).

[133] Nonfinancial support includes monitoring and advisory services and reputational capital. *See* Black & Gilson, *supra* note 131, at 245.

[134] *See id.* at 245-46.

[135] *See* WEILD & KIM, *supra* note 123, at 6.

[136] *Id.*

convey significant control rights to the venture capitalists.[137] Venture capitalists insist on control rights "to protect themselves against the risk that the entrepreneur would not run the firm successfully or will extract private benefits from the firm instead of maximizing its value to all investors."[138] These rights, however, are structured so that they automatically terminate upon an IPO, which ultimately means that full control reverts to the entrepreneur.[139] Thus, the opportunity to regain control through an IPO provides an entrepreneur with a powerful incentive to ensure that the firm succeeds and, thus, is in a position to go public.[140] "In effect, the prospect of an IPO exit gives the entrepreneur something of a call option on control, contingent on the firm's success."[141] Conversely, if the firm is sold to a larger company, the venture capitalists are still cashed out, but control does not revert to the entrepreneur. Instead, control is transferred to the acquiring company.[142]

The disappearance of smaller IPOs decreases the likelihood of a startup eventually going public, which in turn decreases the value of the call option on control received by an entrepreneur. As a result, potential entrepreneurs may be less willing to leave the safety of a secure job to launch a startup.[143] Hence, not only may the Genentechs of our world experience a potential lack of funds, but it is also conceivable that entrepreneurs may not even consider launching such startups in the first place. Either outcome costs the United States untold numbers of jobs and innovations. This costly result can arguably be traced back to the rigidity of the Corporate Finance Rule. If underwriters had been free to charge more for smaller IPOs, they would have continued to pursue them, these deals would not have disappeared, and the preferred path to equity capital and share liquidity would still be open.

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[137] Black & Gilson, *supra* note 131, at 259 (stating that venture capitalists receive "both explicit (for example, the right to remove the chief executive officer) and implicit (for example, the right to decide whether the firm can continue in business through staged funding)" control rights when investing in company).

[138] *Id.*

[139] *Id.* at 261.

[140] *Id.*

[141] *Id.*

[142] *Id.*

[143] *Id.* at 259 (explaining that because failure rate for startup companies is high, potential entrepreneurs need added incentive of post-IPO control to be willing "to leave a secure job to start a new company").

V. Reform Proposal

Underwriting compensation regulation should be abolished, at least with respect to IPOs. The big problem with the regulation is that FINRA's caps appear to be too low but, simply raising them is unworkable. Underwriting compensation involves not only tallying up "items of value," but accounting for underpricing and profits and losses from post-offering market support activities as well.[144] Hence, regulators would be faced with the impossible task of assimilating these moving parts. They also presumably would have to get involved in the pricing of IPOs, a task they are ill equipped to do.

Abolishing the Corporate Financing Rule would allow underwriters to increase compensation when other economic inputs of public offerings shift. Thus underwriters could charge more for smaller IPOs, making these deals profitable again and hopefully reversing their recent steep decline. Abolishment would also have some secondary benefits. It would allow underwriters and issuers to structure more efficient compensation schemes. The parties would no longer be constrained by how a particular component fits within the "items of value" rubric or how FINRA will view and weight it in making its reasonableness-fairness determination. Further, abolishment may make the underwriting market more competitive. Smaller investment banking firms and new entrants could build profitable underwriting businesses through smaller deals and consequently establish the capacity and reputation to credibly pursue larger deals. This increased competition would aid in keeping gross spreads reasonable.

Of course, there is a risk that underwriters will start charging "unfair and unreasonable" compensation post-abolishment. This risk seems remote given issuer management incentives, mandatory disclosure rules concerning underwriting compensation, and the possibility the market for underwriting will become more competitive following abolishment. Additionally, compensation levels will also be restrained by the price of substitutes for underwritten public offerings including direct public offerings,[145] Rule 144A offerings,[146] and reverse mergers.[147] Finally, U.S. compensation levels are also restrained by the

[144] *See supra* text accompanying notes 27-31.

[145] *See* Sjostrom, *Going Public*, *supra* note 17, at 581-85 (discussing direct public offering as alternative to IPO).

[146] *See* William K. Sjostrom, Jr., *The Birth of Rule 144A Equity Offerings*, 56 UCLA L. Rev. 409, 432-41 (2008) (discussing Rule 144A equity offerings as alternative to IPO).

[147] *See* William K. Sjostrom, Jr., *The Truth About Reverse Mergers,* 2 Entrepreneurial Bus. L.J. 743, 743-46 (2008) (discussing reverse mergers as alternative to IPO).

price of going public outside the United States, an alternative that has become more feasible in recent years.[148]

CONCLUSION

The Corporate Financing Rule has no convincing justification and, therefore, provides no real benefits. Yet the rule appears to have significant costs — it prevents underwriters from increasing their compensation in response to changes in the IPO economic model. As a result, smaller IPOs are no longer profitable for underwriters and have virtually disappeared.

Hence, the Corporate Financing Rule should be abolished. This would enable underwriters to charge more for smaller IPOs, making these deals profitable again and hopefully reversing their recent steep decline. While standalone abolishment is likely politically untenable in the current anti-Wall Street climate, it should at a minimum be part of the ongoing financial reform debate as it could be positioned as one component of a larger package that increases overall financial regulation. At the very least, FINRA should explain in detail why the rule is still needed.

[148] *See* Jose M. Mendoza, *Securities Regulation in Low-Tier Listing Venues: The Rise of the Alternative Investment Market*, 13 FORDHAM J. CORP. & FIN. L. 257, 290-94 (2008) (discussing London's Alternative Investment Market as alternative to U.S. IPO).