The Jobs Act Did Not Raise IPO Underpricing

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The JOBS Act was signed into law on April 5, 2012, with the objective of improving access to the public capital market for growth companies. Title I of the JOBS Act amended the Securities Act and the Exchange Act and has been widely recognized as the most significant relaxation of securities regulation in decades. Title I of the JOBS Act includes provisions designed to “de-risk” and “de-burden” the IPO process for emerging growth companies (EGCs) — issuers with pre-IPO revenues of less than $1 billion. The de-risking provisions are intended to enhance the ability to conduct a successful registered offering and to facilitate capital formation at a lower cost. The de-burdening provisions also allow EGCs to scale back disclosures in their IPO filings, delay auditor attestation on internal controls, and adopt new or revised GAAP standards using private company effective dates.

While the goal of the JOBS Act was to ease access to capital, studies have found evidence of an increase in IPO underpricing and higher cost of equity capital for EGC issuers. Using a novel design, we find that changes in overall IPO market conditions explain the apparent increase in IPO underpricing. In fact, EGC issuers that take advantage of the accounting disclosure relief afforded by the JOBS Act raise capital at higher pre-IPO valuation multiples**.** These reduced-accounting disclosure EGCs have more speculative valuation profiles and lower institutional ownership and are more likely to destroy long-term shareholder value in the IPO aftermarket. Indeed, the evidence shows that nearly two-thirds of reduced-accounting EGCs underperformed the market portfolio in the first three years after going public.

A key implication is that individual investors attracted to lottery-type stocks may have been disproportionately exposed to shareholder value destruction post-JOBS Act. Our evidence is relevant for informing the SEC’s efforts to facilitate capital formation while protecting the interests of Main Street investors. The evidence is especially relevant considering the SEC’s rule extending EGC accommodations to non-EGC issuers (SEC Release, No. 33-10699). Under this rule, effective December 3, 2019, all initial registrants can test the waters with certain institutional investors prior to filing a registration statement. This rule gained support for its potential to increase the number of offerings and investment opportunities without raising significant investor protection concerns (SEC Public Statement, 9/26/2019).

We do not dispute that enhancing the ability to conduct a successful registered offering would ultimately provide more opportunities to invest in public companies. Yet, our evidence highlights that regulators should balance the benefits of increasing the number of IPO registrants against the costs of enabling speculative issuers to go public with reduced financial disclosures. With respect to investor protection in the IPO aftermarket, the quality of IPOs is as important, if not more important, than the quantity.

Our evidence calls attention to the risks for Main Street investors of targeting IPO stocks with speculative valuation profiles. While we find evidence that institutional investors use publicly available information to avoid the worst-performing IPO stocks, individual investors tend to ignore firm fundamentals when investing in IPO stocks.

This post comes to us from professors Omri Even-Tov and Panos N. Patatoukas and from Young S. Yoon, a PhD candidate, at the University of California, Berkeley's Haas School of Business. It is based on their recent paper, "The Jobs Act Did Not Raise IPO Underpricing," available here.