

Who needs underwriters?

The case for direct public offerings.



FIELD NOTES

BY ANITA I. ANAND &
LEWIS D. JOHNSON

Last year, Google contemplated going public via a direct public offering (DPO), a type of transaction virtually unknown in Canada and rare in the U.S. DPOs can be an efficient means of raising capital due to the absence of underwriting fees; other factors, such as conducting an Internet offering, having educated investors, or offering debt rather than equity securities, can further lower the cost.

However, without an underwriter's due diligence and "stamp of approval," many investors cannot distinguish between high-quality and fly-by-night issuers. This can be addressed by adopting signaling mechanisms that affirm the firm's credibility, but these costs must also be netted against DPO proceeds.

As part of a larger empirical study on impediments to DPO use in Canada, we conducted two focus groups in Toronto in June 2003. The first group, made up of major regulators and institutional investors, was labelled the "think-tank group," while the second group, composed of capital markets constituents from both the buy (asset management, private equity and hedge fund professionals) and sell sides (investment bankers, technology company officers and securities lawyers) was dubbed the "issuer-underwriter group." Interestingly, one of the participants in the second group was the chairman of the first Canadian company to attempt a DPO.

The first question dealt with barriers to issuing securities over the Internet. The main concern among both groups was the actual sale of the offering: perceived issues included lack of access to potential buyers, lack of secondary market interest, lack of a direct sales force, and the bias issuers have towards selling to high-quality investors (which often remains unful-

filled because of the lack of knowledge and confidence in conveying information over the Internet).

BARRIERS FROM THE INVESTORS' PERSPECTIVE

Next, the groups were asked about the barriers deterring investors from participating in Internet securities offerings. All consensus ideas related to trust and confidentiality: whether the Internet was truly secure, and how well it is regulated. The absence of independent verification was a major issue, and members of both groups questioned the efficiency of a DPO. From the dissemination of information to the pricing of the issue, many participants believed this method to be inferior to traditional capital financing methods. Others stated that raising capital through a DPO could hurt a firm's credibility.

Other perceived shortcomings included broker reluctance and monopolies of issuance. Without a commission, brokers will likely be reluctant to support the DPO transaction, a potentially damaging situation, since most investors use a broker to purchase securities. Monopolies of issuance occur when some companies can perform the transaction better than others, meaning price will reflect ability to execute, rather than value.

POSSIBLE EFFICIENCIES AND INEFFICIENCIES FROM DPOs

The participants were then asked to identify potential efficiencies in using the Internet to complete securities offerings. Both groups felt investors would have better or equal access to information, as well as better access to deals in terms of share allocation. This, to some, meant that investment bank "spinning"—the practice of allocating shares for improper reasons—would be reduced. From an issuer perspective, the obvious cost-benefit of eliminating the

Anita Anand is associate professor of law at Queen's University Law School in Kingston, Ont., and Lewis Johnson is professor of finance at Queen's University Business School. The authors would like to thank SSHRC, Torys and study participants, as well as Dan Teguh, Erik Lockhart and Shirley Taylor.

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underwriter was most commonly cited. Also, the groups felt that issuers would have access to a broader global investor base by utilizing the Internet. Finally, issuers would have better access to capital because they avoid the underwriter “pipeline,” which would enable them to get to the market faster. The think-tank believed issuers could target investors who know and trust the company and reach them more quickly and efficiently. From a capital markets perspective, opinions on the efficiencies gained through DPOs focused on lowering the cost of issuance. These ideas included mitigating effects of biased investment bank research in secondary market trading, and the idea of DPOs as price competition for traditionally inflexible underwriting fees.

Different inefficiencies were also identified by the groups. The think-tank group believed a viable DPO market would bring chaos to the traditional broker network mechanism. They also discussed the fragmented markets in Canada, and the fact that a DPO would probably be harder to bring to market because of heterogeneous legislation across Canada. The self-selection in capital markets, which weeds out bad issuers through underwriters selecting clients, was purported to be threatened by DPO markets.

The issuer/underwriter group focused on the transaction itself, concerning themselves with valuation, and who performs it. Also, free-riding could occur where small investors used the valuations of institutional investors; worse, investors could attempt to call the issuer’s suppliers or partners for information.

REPLACING THE VERIFICATION PROCESS

We asked participants what could be done to replace the verification function of the underwriter. The most popular idea was standardized issuance: a central body, quality-based requirements, and mandatory regulator approval of prospectuses and Web sites were mentioned as possible ways to achieve this. Again, a central marketplace or exchange was proposed to allow comparison between dif-

ferent issues, as was shifting the onus of verification to other parties in the issuer/underwriter group. One participant said investors should do their own research, with issuers using technology, such as hyperlinks within a prospectus, to direct investors to other verifying information. Some suggested that the onus should shift to auditors and lawyers; others suggested a third party should be responsible for verification. Suggested entities capable of filling this third-party role included trade organizations, a ratings agency, or equity/credit analysts.

REGULATORY IMPLICATIONS

Potential regulatory actions were then explored. The participants were unanimous in agreeing that regulation should be streamlined and uniform, and regulatory reform should accelerate the DPO-issuing timeline and be more cost-effective than registering normal securities. They also felt that a national regulator would further streamline the process. Both groups felt that legislation should be customized to accommodate small cap companies, should be based on principles (such as minimum financial standards) rather than rules, and should feature tough enforcement with severe penalties for transgressions.

CONCLUSIONS

Conventional wisdom suggests that DPOs are not cost-effective because of information asymmetries and verification costs borne by investors. However, if firms adopt mechanisms that signal their credibility to the market, they may be able to overcome the verification problem. Furthermore, under certain circumstances, the information gap is narrower and opportunities for improving market efficiency exist. These opportunities may include offerings which are conducted by seasoned companies, offerings of debt securities—especially rated debt—and offerings in which the investors are institutions. In all of these instances, information asymmetries in a DPO are reduced and the transaction may be more cost-effective as a result. ■