

The U.S. Need For Venture Exchanges

Recommendations for the creation of Congressionally-mandated stock exchanges designed to support small-cap companies and their investors and provide the necessary infrastructure to support a resurgence in innovation, job growth and the American Dream.

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By David Weild and Edward Kim

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Executive Summary

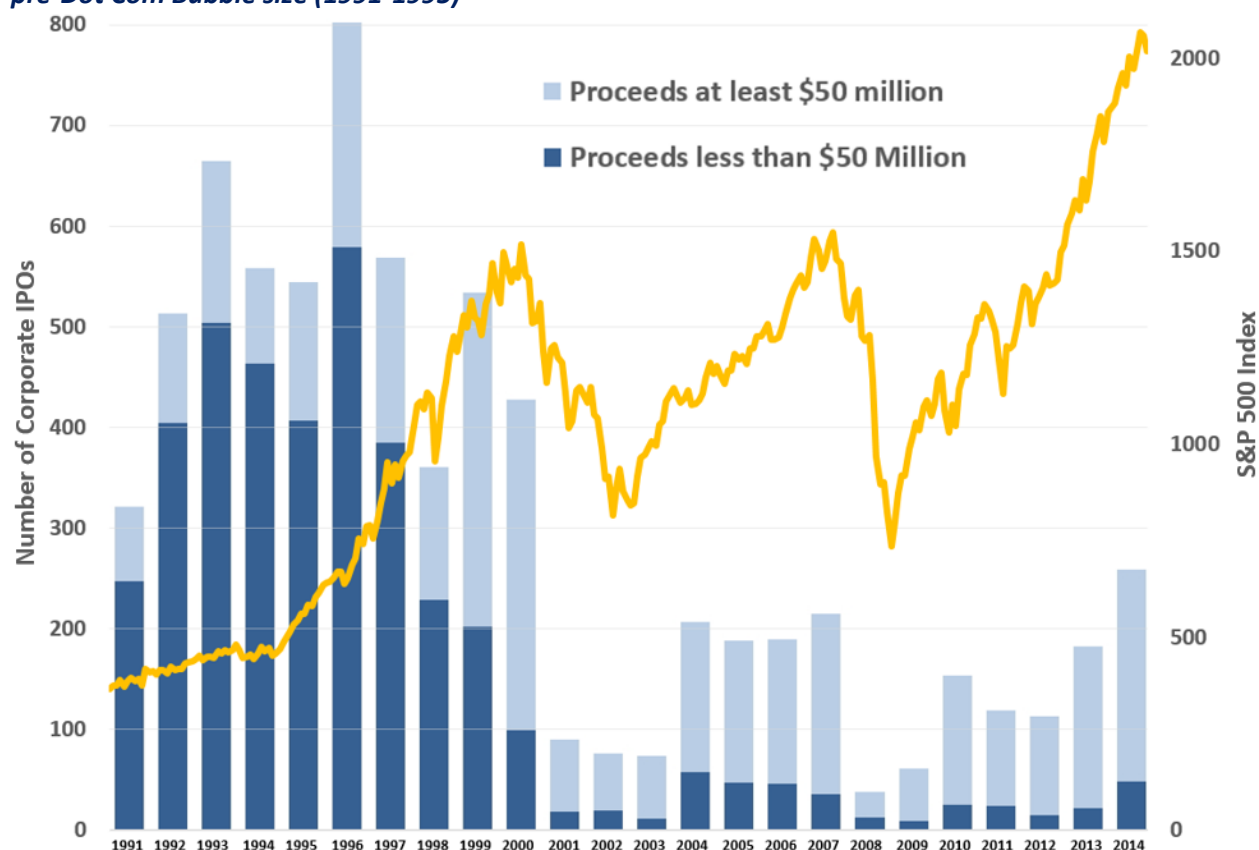
The United States needs a “Venture Exchange” construct that will expand access to capital for entrepreneurs, enable earlier public participation in the company life-cycle, and attract aftermarket support (e.g. research, sales and capital commitment by market makers). One-size-fits-all-stock markets, optimized for large cap trading, have been a significant growth deterrent in the U.S., causing a dramatic and abrupt decline in small IPOs. The U.S. fell from 1st place to 12th in small IPO output behind many smaller economies, and fell to 24th out of 26th in small IPO output on a GDP-weighted basis ahead of only Mexico and Brazil¹ dating back to the 1990s and the widespread adoption of low-cost electronic markets. Certain foreign markets have benefited from their regulators and legislators recognizing the fundamentally different needs of small cap stocks by creating entirely separate markets (what the authors refer to as “Small-cap” or “Venture” exchanges) that embrace lower-cost disclosure models and higher per share market-making incentives. The authors make recommendations for legislators convinced that the United States can reestablish the small IPO market and its associated ecosystem to its former luster as “The stock market that was the envy of stock markets across the world.”

¹ *Making Stock Markets Work to Support Economic Growth: Implications for Governments, Regulators, Stock Exchanges, Corporate Issuers and their Investors*, by Weild, Kim & Newport, OECD Publishing (Organization of Economic Cooperation and Development), July 2013. See http://www.oecd-ilibrary.org/governance/making-stock-markets-work-to-support-economic-growth_5k43m4p6ccs3-en

Need for Dedicated Small-Cap (Venture) Exchanges

While pundits are popping champagne corks in celebration of the best IPO market since the dot com bubble ended in 2000, we sound a note of alarm: While 2014 was the best IPO market in 14 years, it generated fewer IPOs than what is required to stop the U.S. listed markets from shrinking. There were 284 operating company IPOs in 2014 – a pitiful number for a ‘bull market’ (see stock chart below). It takes 360 new listings per year for U.S. stock markets to break even² and it takes 520 IPOs a year to keep up with 3% GDP growth rates.³ We have the largest economy in the world. On a GDP weighted basis, if the United States was performing at the level of some of the better markets (e.g. Canada, U.K., Singapore), the United States would be enjoying an average of 950 IPOs a year. We estimate that the difference between the number of IPOs that we have been doing since 2001 (approx. 150 per year), and what we believe we should be doing (upwards of 950 per year) is worth an incremental 10 million jobs to the U.S. economy.

Despite major bull markets from 2002-2007 and 2010-2014, the IPO market has not recovered to its pre-Dot Com Bubble size (1991-1995)



² Exhibit 10, page 12, *A wake-up call for America*, by Weild & Kim, published by Grant Thornton, November 2009. See

https://www.grantthornton.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/gt_wake_up_call_.pdf

³ Ibid.

The inescapable conclusion is that while the JOBS Act has helped IPOs, it only scratches the surface of what must be done to regain our stature. Speak with current and former stock exchange officials anywhere in the world, and most foreigners say that we've overregulated, overcosted and stifled the very IPO market that once was the source of their envy: The IPO market of the 70's, 80's, and 90's which was the bedrock of U.S. economic leadership in such industries as software, semiconductors, personal computers and biotechnology.

On October 11, 2011, the Wall Street Journal published an OpEd by one of the authors of this paper entitled, "How to revive small-cap IPOs." In it, we first called for the creation of dedicated "small-cap" or Venture Exchanges:

One-size-fits-all stock trading has become a disaster for all but our nation's largest companies. Our rush to cut trading spreads and commissions has made large caps even more active—but we've abandoned the entrepreneur in the process. These are the people who take on most of the business risk and job creation in this country. With such inhospitable stock markets, mergers and acquisitions have become virtually their only outlet to realize value for their hard work.

And as we've so often seen during this tough economy, M&A generates job cuts, not new jobs. That's why young, dynamic companies need renewed capital-market support so they can grow independently without being forced to sell.

What's needed now is a new, parallel market for public companies under \$2 billion in value. Trading rules in this new market would allow for higher commissions, which would provide adequate incentives for small investment firms to get back into the business of underwriting and supporting small-cap companies.

Small capitalization stocks have strikingly different characteristics from large capitalization stocks. Small cap stocks generally lack natural visibility, natural followings and natural liquidity. Small cap stocks trade assymmetrically: Big buyer, no seller. Big seller, no buyer. So, it should come as no surprise that today's "one-size-fits all" market structure, optimized for low-cost trading, index funds and computer-based trading, has precipitated a collapse in the ecosystem that supports these companies. Logically, this is why the United States has seen a decline from nearly 9,000 listed companies in 1997 to approximately only 5,000 today. If the SEC and Congress had not changed market structure beginning with the Order Handling Rules in 1997 and Regulation ATS (Alternative Trading System) in 1998, culminating in Decimalization in 2001, Sarbanes Oxley in 2002 and Regulation NMS (National Market System) in 2006, the American people would enjoy more than 13,000 listed companies versus the current 5,000 we currently have – and more than 10 million incremental jobs.

Prior to 1997, the United States had a small-cap "exchange" with a different structure: It was the dealer market, otherwise known as NASDAQ or the National Association of Securities Dealers Automated Quotation System. Stock trading on this market was quoted, not electronic. The NASD (now FINRA), of which NASDAQ was a subsidiary, was "member-owned." The NASDAQ of today, just like the NYSE, looks nothing like it did in 1997. Today, both are for-profit stock-held corporations whose primary objective is to grow shareholder value rather than to advocate for the members of the ecosystem (the many small investment banks, institutional investors and corporations whose confidence is required to support small cap markets).

Prior to 1997 there existed a vibrant ecosystem of many small investment banks. These banks thrived in small-cap-stock market making and reinvested profits in equity research analysts, research, salesforces, market makers and investment bankers. The most notable of these firms were the so-called “Four Horsemen” –Alex Brown, Montgomery Securities, Robertson Stephens and Hambrecht & Quist. None of these firms could exist on the same scale today. The economic incentives are wholly inadequate to support the required infrastructure. This is the so-called “Ecosystem theory of small IPO decline,” attributed by academics to the work of the authors.

Stated simply, low-cost trading – publicized as a boon to consumers - gutted U.S. capacity to take companies public and to support them. The U.S. stock market no longer has the capital formation capacity that once made it “The stock market that is the envy of stock markets throughout the world.”

In 1994, 162 Banks Acted As A Bookrunner On A Small IPO (< \$50 million). Only 34 Of These Are in Existence Today.

AB Capital & Investment	First Hanover Securities	Lehman Brothers	Robert W Baird
Advest	First Marathon	LH Alton	Robertson Stephens
AG Edwards & Sons	Friedman Billings Ramsey	Mabon Securities	Robinson-Humphrey
Allen & Co	Gilford Securities	Marleau Lemire Securities	Rocky Mountain Securities
Americorp Securities	GKN Securities	Mathews Holmquist	Rodman & Renshaw
Anderson & Strudwick	Glaser Capital	McDonald Investments	Roney Capital Markets
AR Baron	Global Capital Securities	Merrill Lynch	Roth Capital Partners
AT Brod	Goldman Sachs	MH Meyerson	Royce Investment Group
Auerbach Pollak & Richardson	Grady & Hatch	Miller Johnson & Kuehn	RvR Securities
Banc of America Securities	Greenway Capital	Montgomery Securities	Ryan Lee
Baraban Securities	Hamilton Investments	Morgan Keegan	Salomon Brothers
Barber & Bronson	Hampshire Securities	Morgan Stanley	Sands Brothers
Baring Securities	Hanifen Imhoff	Murchison Investment Bankers	Schneider Securities
Barington Capital	Harriman Group	NatCity Investments	Schroder
Barron Chase Securities	Harris Nesbitt Gerard	NatWest Securities	SG Cowen
Beacon Securities	HJ Meyers	Needham	Smith Barney
Bear Stearns	Howe Barnes Investments	Neidiger Tucker Bruner	Spectrum Securities
Brenner Securities	IAR Securities Inc	Nesbitt Burns	Spelman
Chase H&Q	ING Barings	Nomura Securities	Stephens
CIBC World Markets	International Assets Advisory	Norcross Securities	Sterling Foster
Citigroup Global Markets	Investec	Oak Ridge Investments	Sterne Agee & Leach
Commonwealth Associates	Investors Associates	Oppenheimer	Strasbourger Pearson
Comprehensive Capital	J Gregory	Oscar Gruss & Son Inc	Stratton Oakmont
Craig-Hallum Group	James Capel	Pacific Crest Securities	Summit Investment
Credit Suisse First Boston	Janney Montgomery Scott	Pacific Growth Equities	Texas Capital Securities
D Blech	JC Bradford	PaineWebber	Thomas James
Dain Rauscher Wessels	Joseph Stevens	Paragon Capital Markets	Toluca Pacific Securities
Daiwa Securities America	Josephthal	Paribas Capital Markets	Tucker Anthony
Dean Witter Reynolds	JP Morgan Securities	Parker/Hunter	UBS Securities
Deutsche Bank Securities	JW Charles Securities	Patterson Travis Securities	VTR Capital
Deutsche Morgan Grenfell	Keane Securities	Paulson Investment	Wachovia Capital Markets
DH Blair	Kennedy Mathews Landis Healy	Piper Jaffray	Wedbush Morgan Securities
Dickinson	Kensington Wells	Principal Financial Securities	Wells Fargo Securities
Dillon-Gage Securities	Kidder, Peabody	Prudential Securities	Werbel-Roth Securities
Donaldson Lufkin & Jenrette	Kleinwort Benson Securities	RAF Financial	Wertheim Schroder
Equity Securities Investment	Ladenburg Thalmann	RAS Securities	Westfield Financial
Everen Securities	Laidlaw Global Securities	Raymond James	Whale Securities
FAC/Equities	Lam Wagner	Redstone Securities	William Blair
FEB Investments	Lazard Freres	Rickel & Associates	Yamaichi Securities
First Asset Management	LC Wegard	RJ Steichen	Yee Desmond Schroeder
First Equity Corp of Florida	Legg Mason Wood Walker		

In 2014, Only 31 Banks Acted As A Bookrunner On A Small IPO (< \$50 million) and the Number of Bookrunners Declined 81% From 1994 to 2014.

Aegis Capital	Feltl	Newport Coast Securities	Scarsdale Equities
Barclays Capital	Henley	Northland Capital Markets	Stephens
Capitol Securities Mgmt	Jefferies	Oppenheimer	Stifel Nicolaus / Keefe
Chardan Capital Markets	JMP Securities	Piper Jaffray	Summer Street
Cowen	Laidlaw	Raymond James	UBS Securities
Credit Suisse Securities	Leerink Partners	Robert W Baird	Wells Fargo Securities
Dawson James Securities	Maxim Group	Roth Capital Partners	William Blair
Deutsche Bank Securities	MDB Capital Group	Sandler O'Neill	

Viewed the World Over

The United States is still the world's largest capital market. Our innovations in markets, for better or worse, are frequently exported (e.g., derivative securities that contributed to the World Financial Crisis of 2007-2008 which still lingers; Knight Securities once occupied the floor of the old London Stock Exchange) but not always worth emulating.

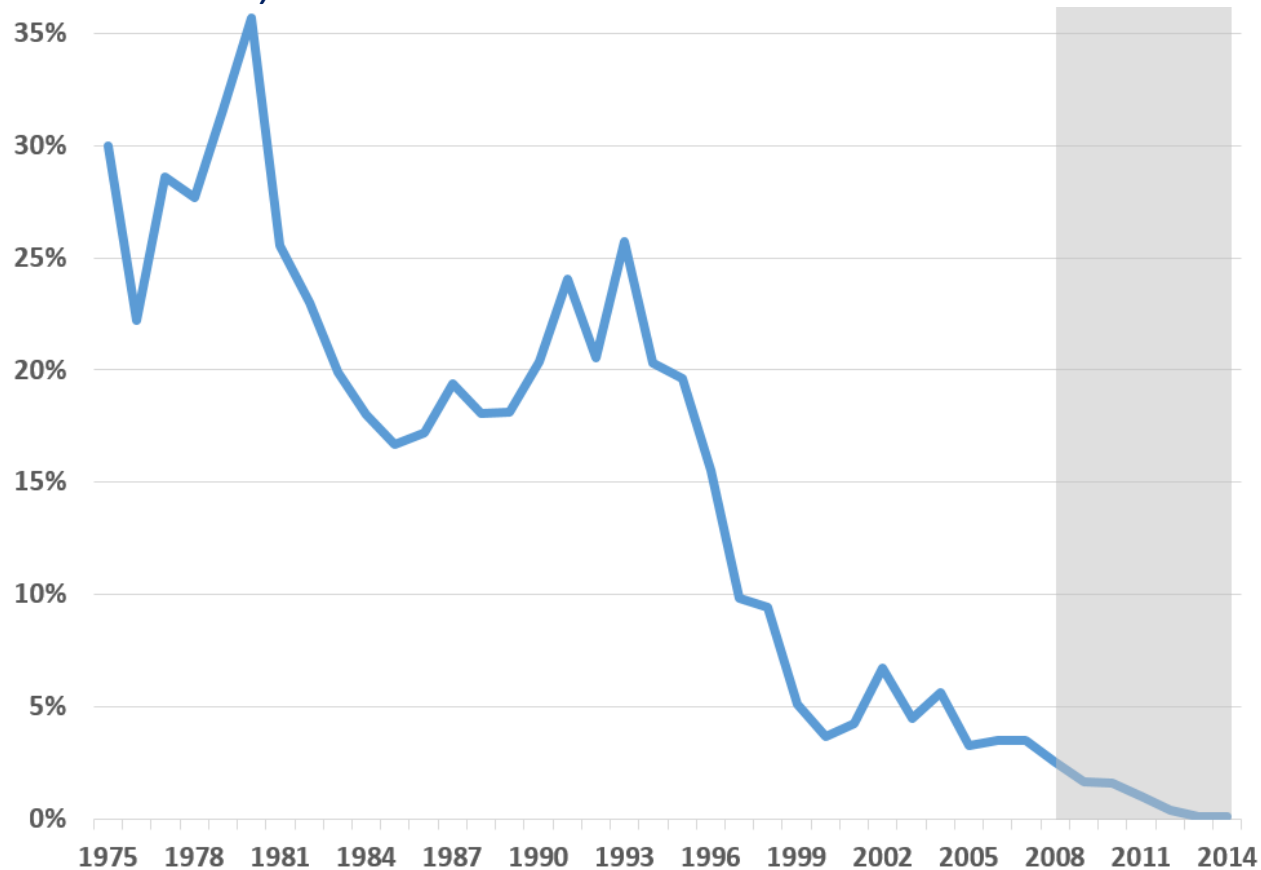
Do not take for granted that the United States will remain the world's largest capital market. Institutional capital is highly mobile. Whether it is Fidelity Investments with operations across the globe, or whether it is Alibaba coming to the U.S. for \$25 billion in capital to be journaled into China, the trends clearly point to increasing globalization of institutional capital. We must make the United States a place that attracts "sticky" capital and where entrepreneurs easily congregate to create jobs through innovation and implementation.

We have a responsibility to get it right and to acknowledge when we get it wrong. The world is watching.

Much like a twelve-step program on the path to recovery, the SEC should acknowledge that the U.S. stock markets are no longer the envy of stock markets across the globe. We know. We ask. We listen. Yet Americans, including SEC Chairs, often repeat this claim even to Congress.⁴ However, when we ask overseas stock exchange executives, equity capital markets professionals in London and institutional investors, whether they envy U.S. stock markets, foreigners generally react with incredulity. What they once envied was Silicon Valley and the IPO market that birthed entire new industries. They cite U.S. leadership in semiconductors, personal computers and biotechnology as prime examples. In the same breath, however, they note the decline in our small IPO markets, the expansive reach and costs of Sarbanes Oxley and Dodd Frank, and the rise of high-frequency trading. They are deeply concerned.

⁴ Chair Mary Jo White, "...the U.S. markets are the envy of the world..." from *Testimony on SEC Budget*, Before the Subcommittee on Financial Services and General Government, Committee on Appropriations, United States Senate, on June 25, 2013 see <http://www.sec.gov/News/Testimony/Detail/Testimony/1365171606059#.VLwM29g5A5s>

Percentage of Venture-Funded Companies that have Gone Public
(Note-shaded area highlights those years that are understated given the relative youth of those venture investments)



Source: National Venture Capital Association, based on number of first venture fundings each year

Large Cap Bias Everywhere We Look

Because of the decline in the small cap ecosystem and the shift to for-profit, stock-held exchanges, U.S. markets are dominated by thought leaders, institutions and regulatory bodies with experience, expertise and economic incentives derived disproportionately from large cap stocks and the firms that focus on them.

In our view, large-cap bias permeates the SEC (Securities & Exchange Commission), FINRA (Financial Industry Regulatory Authority), the NYSE, NASDAQ, SIFMA (Securities Industry Financial Markets Association) and DTCC (Depository Trust Company) – every institution that has a voice. Small cap companies (and their investors and their intermediaries) by contrast, are inadequately represented, and their voices are drowned amid the preponderance of large cap trading-oriented investors. Regulators have pursued an ideology that low-cost trade execution is the only measure that matters. Even that measure is perversely off the mark: Best execution is defined as the price of trade execution relative to the NBBO (National Best Bid and Offer) at the time of execution when in reality it should be measured from the time at which the order is received (not executed). Large orders take time and care to execute and information leakage can cause the stock to move adversely in one direction or the other. This is known as “slippage.” Small orders are sold (payment for order flow) and sometimes shopped across venues looking for the “best return” (not “best execution”) to the originating broker dealer.

The most recent example of domination by large capitalization interests is revealed in an examination of the SEC’s much trumpeted “Market Structure Advisory Committee”⁵ – announced just this January 13, 2014:

Members of the Equity Market Structure Advisory Committee are:

- **Matthew Andresen**, Co-Chief Executive Officer, Headlands Technologies LLC
- **Reginald Browne**, Senior Managing Director & Global Co-Head, ETF Group, Cantor Fitzgerald & Co.
- **Kevin Cronin**, Global Head of Trading, Invesco Ltd.
- **Brad Katsuyama**, President and CEO, IEX Group Inc.
- **Ted Kaufman**, Professor, Duke University Law School and former U.S. Senator from Delaware
- **Richard Ketchum**, Chairman and CEO, FINRA
- **Manisha Kimmel**, Managing Director, Financial Information Forum
- **Mehmet Kinak**, Vice President and Head of Global Equity Market Structure and Electronic Trading, T.Rowe Price Group
- **Andrew Lo**, Charles E. and Susan T. Harris Professor of Finance and Director, Laboratory for Financial Engineering, MIT Sloan School of Management and Chairman and Chief Investment Strategist, AlphaSimplex Group
- **Joseph Mecane**, Managing Director, Barclays PLC
- **Jamil Nazarali**, Senior Managing Director & Head of Execution Services, Citadel Securities
- **Eric Noll**, President & CEO, Convergenx Group
- **Maureen O’Hara**, Robert W. Purcell Professor of Finance, Johnson Graduate School of Management, Cornell University and Chairman of the Board, Investment Technology Group Inc.

⁵ See SEC Press Release at <http://www.sec.gov/news/pressrelease/2015-5.html#.VLmjuNg5A5s> entitled, *SEC Announces Members of New Equity Market Structure Advisory Committee: Committee Comprised of Experts with Diverse Backgrounds and Viewpoints*

- **Joe Ratterman**, CEO, BATS Global Markets Inc.
- **Nancy Smith**, Corporate Secretary & Chief Integration Officer, AARP
- **Chester Spatt**, Kenneth B. and Pamela R. Dunn Professor of Finance, Tepper School of Business, Carnegie Mellon University and Director of its Center for Financial Markets
- **Gary Stone**, Chief Strategy Officer, Bloomberg Tradebook LLC

We applaud the inclusion of institutional investors who have knowledge of small cap investing, namely Kevin Cronin of Invesco and Mehmet Kinak of T. Rowe Price.

We applaud as well the inclusion of Ted Kaufman who, in his December 16, 2009, speech on the floor of the United States Senate asked,

“How can we create a market structure that works for a USD 25 million IPO — both in the offering and the secondary aftermarket? If we can answer that question, Mr. President, this country will be back in business.”⁶

We are extremely concerned, however, by the absence of participation by middle market investment banks including such firms as Piper Jaffray, Cowen & Company, William Blair, Leerink Partners, Robert W. Baird, Pacific Crest Securities (recently acquired by KeyCorp) and Stifel Financial. Middle market investment banks, whose numbers were once great, are now an endangered species. These firms reflect and are emblematic of the dwindling infrastructure (ecosystem) that the United States depends upon to support a robust small IPO and aftermarket. Their decline dates back to the disappearance of the Four Horsemen and has continued unabated into recent years with the sale (some would say collapse) of firms like Keefe Bruyette & Woods and Think Equity as well as the January 8, 2015, announcement that Standard Chartered Bank would close its equity sales and research business.⁷

⁶ See University of Delaware Library, Ted Kaufman, United States Senator for Delaware, *Kaufman Calls Decline in IPOs “Choke Point” to Job Creation, Economic Recovery* : “The failure of Wall Street to provide capital to small companies may be costing our economy millions of foregone jobs,” December 16, 2009 at http://green.lib.udel.edu/webarchives/kaufman.senate.gov/press/press_releases/release/-id=352c7e34-1cad-4ad3-b31c-c267bd492d1a.htm

⁷ New York Times Deal Book, January 8, 2015, *Standard Chartered to Close Equity Sales and Research Business*, by Neil Gough. See <http://dealbook.nytimes.com/2015/01/08/standard-chartered-will-close-equity-sales-and-research-business/>

The Early NASDAQ, London AIM and Toronto TSX Venture Exchanges

A number of small-cap or Venture Exchanges have been successful in the past. Today, all have converted to for-profit public shareholder models contributing to the deterioration in the small cap ecosystem in each of the US, U.K. and Canada. As the small-cap ecosystem shrinks, so do research, sales and marketing support and capital available to support liquidity. When the “aftermarket” declines, IPO production declines.

The Early NASDAQ – Nasdaq was established in 1971 as a member-owned trade reporting facility. It was not a “stock exchange” in the legal sense (not an SRO or Self-Regulatory Organization) but was a facility of the NASD (National Association of Securities Dealers) which itself was “Member-owned” (no public shareholders). Trades did not occur on Nasdaq in its infancy but occurred in the over-the-counter market between and within broker-dealers (its member firms). The primary innovation of Nasdaq in the early years was to create price transparency and to allow members to advertise their activity (volume) in any given Nasdaq stock.

The Intel Corporation went public on Nasdaq in 1971. It did not meet the qualifications of the listed stock exchanges at the time. The early Nasdaq was in essence a Small-Cap Exchange. It was the original U.S. Venture Exchange.

Notably, in the early years of NASDAQ, market makers could advertise their markets but they were not formally obligated to buy significant amounts of stock. The market was a telephone “quoted” market where dealers could back away from orders and thus manage their risk. Their quotes were not live orders that anyone could “hit” electronically, as they can today. When companies had poor results, dealers would short or back away and stock prices would decline. When companies had good results, dealers would get on the phone and “talk the stock up.” Wide quoted spreads which created “effective”⁸ tick sizes of as much as 25 cents per share, provided ample incentives for market makers to commit capital – whether to short stock to provide an institution with an initial position (to “get the investor going”), or to buy a block of stock from an investor at or below the “bid” side of the market and offer it to brokers to make sales calls “net” with 25 cents per share to the stockbroker as a maximum incentive. Liquidity in small-cap stocks was thus “manufactured” by the dealers and their salesforces.

Admittedly, there was quite a bit of conflict here. Salesmen (brokers) were motivated by money. Firms tried to control for this by investing in equity research and the so-called “Competition of ideas” – the fact that the typical firm had many stocks from which to choose under research coverage, caused them to disproportionately market their “buy” rated ideas while shying away from “hold” or “sell” recommendations.

Reg. ATS came in 1998 and represents the dawn of widespread electronic order book markets in the United States. These caused the effective tick size, the smallest increment in which a stock can trade, to

⁸ While the actual permissible minimum “tick” size was in the pre-decimalization period 3.125 cents (1/32nd), the markets of the 70s and 80s were quoted and the convention was to quote in 25 cent increments. Thus, while an institution might be able to negotiate less than a 25 cent increment (usually 1/8 or 1/16), many orders would be marked up a ¼ point or 25 cents which was thus the “effective” tick size.

drop from 25 cents per share to 3.125 cents per share – at the same time that the internet enabled widespread self-directed discount retail investing collapsing the commissions charged by retail brokers. While many micromarket economists will argue cause-and-effect here, for those of us that ran these businesses (David Weild co-chaired strategy for investment banking, equity research, institutional sales and equity trading at Prudential Securities), we reacted to the changes by cutting research commitments, capital commitments, and investment banking support of small capitalization companies. The profitability of \$50 million IPOs was suddenly one-third of what it had been pre-Reg. ATS. The collapse of the ecosystem accelerated while a series of new trading-focused for-profit competitors to Nasdaq forced Nasdaq to convert to a for-profit company itself with public shareholders in order to raise adequate capital to remain competitive.

Today, small capitalization companies are frequently seen to announce good news but not enjoy the benefit of a positive reaction by the stock. Why? Because intermediaries are needed to market small cap stocks to investors, and under the current system, no one can earn a living bringing new buyers into smaller stocks.

LSE's AIM (London Stock Exchange's Alternative Investment Market) – AIM was founded in 1995 as a submarket of the London Stock Exchange. As of December 2014, there was a total of 1,104 companies listed on the AIM market including 885 from the U.K. and another 219 International.⁹ The U.K. population is one fifth that of the United States so on the domestic side alone, this would be the equivalent, in U.S. terms, of contributing 4,425 (885 x 5) listed companies to the U.S. markets. An AIM-type market thus has the potential to nearly double the current population (approximately 5,000) of publicly listed companies in the United States. The AIM peaked in 2007, before the Financial Crisis, at 1,694 public companies – nearly twice the current number of listed companies. On a population-weighted basis, this would be the equivalent of adding 8,470 publicly listed companies to the U.S. listed markets – a number not seen in the United States since before the introduction of Reg. ATS in 1998.

Students of stock market history will note that most of AIM trading is based on a clone of the original NASDAQ dealer system called SEAQ. "NASDAQ" stands for "National Association of Securities Dealers Automated Quotation" system while "SEAQ" stands for "Stock Exchange Automated Quotation" system. Ironically, representatives of the London Stock Exchange now travel to the United States to solicit U.S. companies to list on the AIM.¹⁰ U.S. companies cite the lack of Sarbanes-Oxley in the U.K., lower ongoing reporting costs on AIM, and market making as attractants. However, the company review process skips the FSA (the U.K. equivalent of the SEC) and is outsourced to underwriters who are known as NOMADS or Nominated Advisors. These NOMADS are responsible for due diligence and disclosure but critics say that the process is uneven and stigmatizing. For this reason, we would prefer to keep the SEC in this role in the United States.

⁹ See <http://www.londonstockexchange.com/statistics/historic/aim/aim-statistics-archive-2014/dec-14.pdf>

¹⁰ *London Stock Exchange officials recruit businesses in Denver*, January 19, 2015, by Aldo Svaldi, The Denver Post, see http://www.denverpost.com/business/ci_27351789/lodon-stock-exchange-officials-recruit-businesses-denver

Actual Invitation to an Upcoming AIM New Business Event to be Held in Miami, Florida on March 10, 2015.

Hello,
You are invited to the following event:

**THINK BIG, AIM HIGHER: RAISING
CAPITAL THROUGH LONDON'S
INTL GROWTH MARKET**

Event to be held at the following time, date, and location:

- Tuesday, March 10, 2015 from 8:00 AM to 10:00 AM (EDT)




The Beacon Council
80 Southwest 8th Street
#2400
Miami, FL 33130

[View Map](#)

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Criticisms of AIM – In 2007, The Guardian reported that SEC Commissioner Roel Campos created a stir in London when he likened AIM to a casino saying, "I'm concerned that 30% of issuers that list on AIM are gone in a year." The article¹¹ went on to say that "The LSE, which controls AIM, retorted that the number of companies that go into liquidation or administration in a year is actually fewer than 2%." What people generally don't understand is that the "expected life" of a listing, even in the United States, where companies are more mature, is only approximately 7 years. It stands to reason that smaller companies will be merged and delisted from exchanges at higher rates than larger companies. From a public policy perspective, however, they also represent materially less risk exposure to the public exactly because they are smaller: On February 27, 2015, the market value of Apple Computer was approaching \$750 billion. This is the equivalent of the combined values of 7,500 companies of \$100 million in market value (the United States only has 5,000 listed companies). Clearly, the bigger systemic threat to the U.S. economy is not the churn in small companies, but in not providing a suitable "Venture Exchange" for them to list. Intel Corporation, which went public in 1971 in an \$8 million IPO, was only

¹¹ The Guardian, *City hits out over US 'casino' jibe at Aim*, by Jill Treanor, March 10, 2007 See <http://www.theguardian.com/business/2007/mar/10/1>

three years old and unprofitable on an operating basis. It missed delivery of its first product and the stock price was cut more than fifty percent. Intel listed on the early Nasdaq – the original U.S. Venture Exchange – that inspired President Jiang Jemin in 1998 to call the NASDAQ Stock Market, “...the crown jewel of the U.S. economy.”

One of the authors of this study conducted a series of meetings several years ago with the then-head of the AIM market in London, AIM market makers and institutional investors on AIM. Dealers and institutional investors both said that dealers were feeling pressure as the LSE, in pursuit of its own profits, moved the largest AIM stocks from the dealer trading platform to the electronic bulletin board or CLOB (central limit order book). These more liquid AIM stocks were said to be still “AIM Listed” but now trading on the same platform as stocks in the Major Market (the LSE version of the “Big Board” in the United States). The impact was said to be greater profits for the LSE and lower profits for the dealer (market maker) community.

TSX Venture Exchange (TMX Group’s small cap exchange) – The TSX Venture Exchange traces its roots to the merger of the Vancouver Stock Exchange and the Alberta Stock Exchange in 1999 to form the Canadian Venture Exchange. In 2001, the TSX Group (Toronto Stock Exchange, now known as TMX Group) purchased the Canadian Venture Exchange, converting it at some point from a dealer market to an auction-style electronic stock market. We believe that, while this move was in the best economic interests of TMX Group, it likely siphoned off economics from the dealers (market makers) and put pressure on the Canadian small cap ecosystem. In a recent article¹² in the Financial Post, “Can the once mighty TSX Venture Exchange be saved?” it is clear that the cumulative market value of the exchange is less than in 2001 when it was acquired by TMX Group, and market participants are voicing concern that access to capital and liquidity are extremely poor. Despite this, the TSX Venture Exchange still has over 2,100 listed companies with an aggregate value of approximately CAD\$33.1 billion (U.S.\$26.5 billion). 2,100 listings is astonishing when one considers that the Canadian economy is one ninth the size of the U.S. economy, making it a 19,000 U.S.-listed-company weighted equivalent, and yet the entire U.S. listed stock market (NASDAQ plus NYSE) consists of only 5,000 listed operating companies.

We believe that the member-owned model was and would be superior to balancing interests and that stock exchanges with public shareholders will inevitably be tempted to siphon economics in ways that undermine the ecosystem required to support a vibrant small cap marketplace.

¹² Financial Post, December 27, 2014, *Can the once mighty TSX Venture Exchange be saved?*, by Peter Koven, see <http://business.financialpost.com/2014/12/27/can-the-once-mighty-tsx-venture-exchange-be-saved/>

Recommendations for Venture Exchanges

RECOMMENDATIONS FOR PUBLIC MARKET VENTURE EXCHANGES – Our discussion of Small-Cap or “Venture Exchanges” generally presupposes public markets (e.g., the Nasdaq Stock Market of the ‘70s and ‘80s, the London AIM and the Toronto TSX Venture). Public Venture Exchanges are essential to restore higher economic growth rates. Moreover, Private Market Venture Exchanges may also fill another void in the U.S. arsenal of infrastructure required to support the entrepreneurial economy. As a result, we are also making recommendations for Private Market Venture Exchanges (see “Recommendation for Private Market Venture Exchanges” below).

Governance – “Venture Exchanges” should be chartered separately by the SEC. A distinct set of rules – apart from traditional stock exchanges and ATs (Alternative Trading Systems) – For example, “Reg. Venture Exchange,” would be enacted – either in Congress with the support of the White House, or through the SEC’s broad exemptive authority (which they have historically been reticent to use without clear signals from Congress).¹³ In order to sustain and nurture small-cap liquidity:

- **Venture-Exchanges Should be Member-Owned Exchanges** – As seen from our preceding discussion of early Nasdaq, the LSE AIM and the TSX Venture Exchange, the for-profit, stock-held ownership structure of the U.S. stock exchanges puts stock exchanges in competition with value providers¹⁴ (broker/dealers that provide research, sales and capital to support liquidity). As a result, the for-profit shareholder model puts shareholders’ needs for profits ahead of the health and well-being of the ecosystem and the well-being of small cap companies that generate very little trading profit. As a result, we believe that Venture-Exchanges should be Member-Owned and that members should be Broker-Dealers who can receive capital calls in line with their size – broken into three tiers – Large, Medium and Small – to provide balanced representation on the Board of Directors. There should also be an Investor Advisory Committee and a Corporate Issuer Advisory Committee, each with the right to review all material rule changes and make recommendations to the Board.
- **Creation of a Separate Venture Exchange Division at the SEC** – A separate Venture Exchange Division of the SEC should be established to put focus on the specialized and distinct needs of the small-cap marketplace. It should be staffed with financial professionals (and not simply lawyers) and should be tasked to nurture a revival in small IPOs. The division would ensure a balancing of interests among the Venture Exchanges themselves, corporate issuers, intermediaries (the broker-dealers who provide research, sales and marketing and liquidity) and investors. It would horizontally integrate disciplines in:
 - **Listings rules, disclosure, and use of shelf registrations to facilitate lower cost capital formation** (currently within the Division of Corporation Finance) – We need lower cost disclosure (possibly along the lines of Reg. A+) for the smallest companies

¹³ Congress appropriates the SEC’s budget. The SEC is naturally hesitant to take controversial positions where the SEC Chair is called to defend the SEC’s actions and risk cuts to the SEC’s budget.

¹⁴ See “SIFMA Calls For Review of SRO Structure” at <http://www.sifma.org/newsroom/2013/sifma-calls-for-review-of-sro-structure/> “Exchanges Compete with the Broker-Dealers they Regulate. Combined with the transformation of exchanges into for-profit enterprises in search of ways to expand their businesses, exchanges and broker-dealers have become direct competitors in many aspects of their businesses. Most prominent is the competition for order flow between exchanges and broker-dealers.”

and broad allowance of shelf registrations for any issuer that is current with disclosure.

- SEC review of disclosure will support confidence.
 - The disclosure regime should be scaled – Reg. A+ disclosure adopted at the low end. Something stronger for larger listed companies.
 - State regulation should be pre-empted by an “Exchange Listing” exemption for all Venture Exchange listed securities.
- **Trading rules** (currently within the Division of Trading & Markets) - Trading in U.S. equities markets is “one-size-fits all” optimized for the trading of large-cap stocks - a description that was first coined¹⁵ by us and has subsequently been repeated in Congress and at the SEC. Why is this important? Because small cap markets are “asymmetrical” order-book markets with no “network effect.” They lack the natural visibility and liquidity of large cap stocks. By applying a highly price-competitive market structure to small cap trading, the U.S. has experienced a deterioration in large-buyer (and seller) liquidity and a contraction in the small-cap ecosystem (IPO on-ramps). In addition, because well more than 90% of stock trading occurs in stocks that are larger than \$2 billion in market value, we find that many regulators bring large cap bias in their approach to small cap stocks. Venture Exchanges should be:
- **Exempt from the Order Handling Rules (but not the Manning Rule).**
 - **Exempt from Reg. ATS and Reg. NMS.**
 - **Exempt from UTP (Unlisted Trading Privileges – Rule 12f-2).**
 - **Exempt from Decimalization.**
- Venture Exchange listed companies should be:
- **Exempt from Sarbanes-Oxley.**
 - **Exempt from State Blue Sky.**
- **Enforcement** (currently within the Division of Enforcement) – Small cap markets need to prioritize enforcement over prevention. In our dealings with former SEC Commissioners, it became apparent that high cost regulation and low-cost trading may have been intended by some at the SEC and FINRA to prevent sales practice abuses. However, this cure was worse than the disease because it gutted the capital formation engine and source of economic renewal for the entire U.S. economy. When policymakers incentivize more research, sales and trading, there will undoubtedly be more sales abuses - including so-called “pump and dump” schemes. The SEC and FINRA must not be shy about putting flagrant offenders out of business and, for this reason, we think that a special Enforcement Group within a Venture Exchange Division and at FINRA, may be needed.
- **ETFs and Index Funds** (currently within the Division of Investment Management) – ETFs and Index Funds are harmful especially to progressively smaller capitalization stocks. By taking a supply of securities off the market, they undermine liquidity in already less liquid stocks. They also cause consumers to take short-cuts in investing by buying “themes” and “baskets” in lieu of understanding company fundamentals. This likely undermines the “entrepreneurial IQ” of the American populace, dulling

¹⁵ *A wake-up call for America*, by Weild & Kim, p. 20, November 2009, “In an epic case of unintended consequences, one-size-fits-all market structure added liquidity to large cap stocks, but...created a black hole for small cap listed companies. In addition, public companies find themselves in a market environment with a lack of research support, greater systemic risk and volatility, and structural impediments that block them from going private.”

the appetite for education about business and entrepreneurship. Worse, most ETFs and Index Funds are market cap weighted. While they purport to invest in indices, for a variety of liquidity and cost issues, most intentionally avoid investment in the smallest stocks, thus further siphoning capital away from this market segment. Finally, ETFs and Index Funds don't buy new issue stock offerings. The more ETFs and Index Funds grow, the more capital is taken away from capital formation and job growth. Policymakers, at a minimum, should require that all ETFs and Index Funds place standing orders on all offerings.

- **Creation of Separate Venture Exchange Groups within FINRA and DTCC** – Again, we need to keep the focus on the needs of this ecosystem. Smaller FINRA member firms complain that FINRA and DTCC are creating unnecessary cost and friction in the small cap ecosystem. Broker-Dealers complain, for example, that they are searching for compliance vendors to improve compliance, but FINRA, as a matter of policy, refuses to share its knowledge of outside compliance service providers. As a consequence, well-intended broker-dealers make completely avoidable mistakes in compliance. This is not in the best interests of anyone. Most in the industry understand that FINRA and DTCC's revenues are largely derived from the big Wall Street firms and that the big Wall Street firms' business is disproportionately large-cap. Most in the industry also understand that SIFMA (the major industry trade association) is dominated by the big Wall Street firms. Clearly, Congress and the SEC must come up with a construct that institutionalizes and perpetuates a discipline in small-capitalization stocks and the care and feeding of the small-capitalization ecosystem. It should be mandated that:
 - **DTCC is required to provide electronic settlement to Venture Exchange listed stocks.**
 - **Broker-dealers with equity powers are required to allow stock brokers to solicit all Venture-Exchange listed stocks.**
 - **Broker-dealers are required to allow customers to buy Venture-Exchange listed stocks on margin.**
 - **Broker-dealers and investors are required to "Hard locate" shares to borrow before shorting any common stock.**
 - **Market Makers are given an exemption whereby any investor that fails-to-deliver securities must be issued a "buy-in" 24 hours after the failure-to-deliver and cut off from further activity with the broker-dealer until such time as the failure is rectified.**
- **Adequate Ecosystem Economics** – Intermediaries and service providers are essential to providing support for small cap companies. That support comes in three forms – sales and marketing support, equity research coverage and market making that employs capital to shoulder risk (drive large buyer liquidity – more liquidity drives more institutional investment in these stocks). Unlike large-cap markets where liquidity is naturally occurring due to the so-called "network effect," small-, micro- and nano-cap liquidity has always needed to be supported. That support must be paid for through some combination of higher commissions, higher tick sizes and trading spreads, or direct subsidies (the old specialist system on the NYSE required specialists to subsidize liquidity in small cap stocks in exchange for making excess profits in large cap, naturally liquid stocks) and affirmative obligations on market makers. As a result: Venture Exchanges must be:
 - **Allowed to list stocks up to \$2 billion in market value – \$2 billion is still considered small-cap by most institutional investors. A population of larger than \$250**

million market value stocks (the ceiling for the SEC Advisory Committee on Small and Emerging Companies) will be essential to generate enough economics to grow the ecosystem and create sufficient on-ramps to drive IPO production and support.

- Allowed to compete for listings up to \$2 billion in market value (with a CPI escalator) and larger (higher profits in larger stocks creates higher economics to build bigger IPO on-ramps) – Venture Exchanges must be allowed to recruit listings from other stock exchanges and vice versa. This will enable the Venture Exchange ecosystem to obtain critical mass much sooner than if it was dependent on the IPO market.
- Given the authority to set minimum commissions charged by participating brokers.
- Given the authority to set minimum tick sizes and trading spreads by market makers.
- Given the authority to set affirmative requirements of market makers.

*Ultimately, the success of Venture Exchanges hinges more on the profitability of the Ecosystem (Intermediaries and value providers) than it does on the profitability of the Venture Exchange itself. This is why public-shareholder based stock exchanges are poor custodians of venture-exchanges because they are naturally more interested in shareholder profitability than in ecosystem profitability. **As a practical matter, this will require an absolute exemption from such pro-price competition rules as OHR and Regulations ATS, NMS, Decimalization and Unlisted Trading Privileges (UTP).***

- **Extension of Title 1 JOBS Act Research Rules to All Venture Exchange Listed Companies –** The JOBS Act improved the ability and lowered the cost, of sell-side equity research analysts, to work with investment bankers. These liberalizations should be extended to all Venture Exchange listed companies – not just on the IPO. Specifically,
 - Investment bankers should be able to arrange analyst communications with investors.
 - Analysts should be able to join investment bankers in meetings with company management.
 - Analysts should be able to participate in road shows (this would go beyond the JOBS Act)
 - Research on Venture Exchange listed companies should be permissible before and after any IPO or follow-on offering.
 - Congress should limit liability for research published before an IPO - We understand that the reason why EGC (Emerging Growth Company) IPO research has not been published before the IPO, as is the case in Europe, is because of concerns over liability.
- **Clarity On What Constitutes Equity Research –** Congress or the SEC should specifically exempt published materials that do not include securities price targets or recommendations (e.g., Buy, Sell, Hold) from the definition of “Research.” FINRA rule 2711 is ambiguous as to what constitutes equity research, thereby restricting the flow of information in support of smaller market capitalization stocks.
- **Disclosure of Investor Long Positions –** SEC Form 13F ownership information and transparency breaks down in small-cap stocks because quarterly reporting is limited to investors with more than \$100 million in qualifying assets. Most micro- and nano-cap investors manage less than \$100 million in assets because of liquidity constraints. We

believe that managed portfolios all the way down to \$10 million in size, including family offices, should disclose all long (and short) positions on a quarterly basis.

- **Disclosure of Investor Short Positions** – We continue to be disturbed that the SEC does not require the disclosure of short positions on the same basis as long positions. Corporate issuers have the right to decline a meeting with an investor who has established a short position in the stock. Corporate issuers have the right to spend their time in ways that are not contrary to the interests of the Company’s owners (investors). However, without the disclosure of which investors short stock and the types of stock that they short, management’s limited and valuable time – time that would be better put to use managing the Company and creating jobs – is squandered. Worse, some short sellers spread rumors, knowing that it is virtually impossible for the public to attribute the source. Just as there is information value to the rest of the market in who is long a stock (high quality investors attract other long investors), there would also be information value to the rest of the market in who is short a stock. We believe that the lack of disclosure around short-selling undermines investor confidence and the rights of corporate issuers.

RECOMMENDATIONS FOR PRIVATE MARKET VENTURE EXCHANGES - While most students of stock market structure will view “Venture Exchanges” as a public market construct, enhancements to the regulatory framework for private markets are also needed. However, we view Private Market Venture Exchanges, open to only accredited investors and institutional buyers, to represent a partial remedy to the collapse in the small IPO market. “Private Market” Venture Exchanges should not be seen as a substitute for a well-thought out “Public Market” Venture Exchange construct. Private markets would benefit from the inclusion of:

- **Basic disclosure** – The requirement of annual financial statements (not audited) for any company that has raised over \$1 million from outside investors.
- **A consolidated tape** – Activity in all secondary markets should be reported centrally by all market participants, and this information feed should be broadly distributed. The simple distribution of pricing information broadly should not be deemed a “solicitation.”
- **Freedom to solicit accredited investors** – States’ regulations should be pre-empted and brokers should be free to solicit in the private aftermarket any accredited or institutional investor. Non-accredited investors should be off limits.

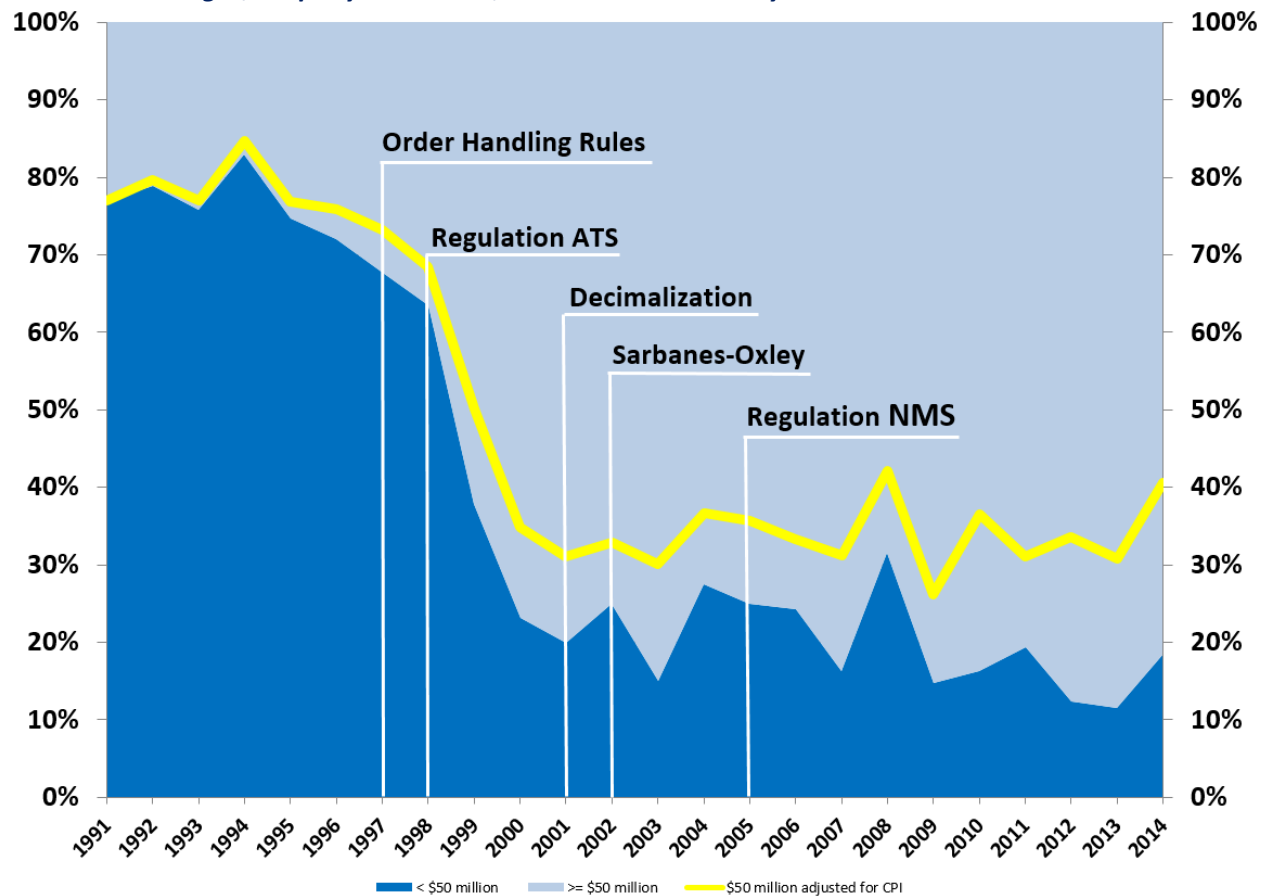
Conclusion

In our work for the Organization of Economic Cooperation and Development (OECD), we examined IPO markets throughout the world. It became obvious to us that the incentives and disincentives created by governments and regulators are the major determinant of the success (or lack thereof) of small IPO markets (and the aftermarket). The inescapable conclusion is that the collapse of the small IPO market in the United States was caused by ill-conceived and nearsighted public policy and that it can be rectified by improved and farsighted public policy that includes the creation of a regime designed to meet the very different needs of small-cap public companies. Intelligently designed “Venture Exchanges” would create a foundation for a resurgence in entrepreneurship, innovation and job creation. We believe that, once established and after perhaps a decade of operation, Venture Exchanges would lead to the creation directly (by companies accessing and investing capital) and indirectly (“multiplier effect” of jobs being created in the service sector of the economy because of the money spent by these companies and their employees) of 10 million jobs for the U.S. economy.

The ability of the United States to sustain itself as a world leader may rest on our ability to reverse the decades long trend of lower company start-up rates and lower IPO rates. Higher levels of entrepreneurship are the bedrock of a vibrant economy. The creation of Venture Exchanges, and the natural advocacy for entrepreneurship that would emerge from these exchanges, is one of the single most important actions that policy leaders can take to reignite the American Dream and restore America’s position as the “Capital market envied by capital markets throughout the world.”

Appendix

The Small IPO Collapse Coincided With The Policy-Driven Shift To Low-Cost Electronic Trading. Venture Exchanges, Properly Structured, Could Lead A Recovery.



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About IssuWorks

IssuWorks is the brainchild of noted Wall Street executives, including David Weild and Ed Kim, whose work is credited with having led to The JOBS Act. IssuWorks uses technology, data and people to help corporate issuers and investment banks significantly improve the marketing and distribution of new issues and to better support companies in the aftermarket. This leads to better performance for public companies and their investors. The mission of IssuWorks is to be the global leader in equity distribution and marketing platforms to complement traditional investment banks. Our clients include both corporate issuers and investment banks.

About Weild & Co.

Weild & Co. is the investment banking arm of IssuWorks. Weild & Co. represents companies and investment banks with a securities distribution approach that allows managements and investment banks to reach longer-term and smaller institutional investors. Weild & Co. also provides advisory and placement services but does not accept commissions from investors.

About the Authors

David Weild is Chairman and CEO of IssuWorks and its broker dealer Weild & Co. He is a Former Vice Chairman of The NASDAQ Stock Market who ran its listings businesses in the U.S., Europe, Asia and Latin America. The studies that David co-authored with Ed Kim documented the long-term decline in equity capital formation in the United States and provided the core arguments that gave rise to the JOBS Act and many of the specific provisions contained in the JOBS Act. For these reasons, he has been called "The father of the JOBS Act" (Forbes). David has worked on over 1,000 public equity offerings during the course of his career in senior management at a major Wall Street firm where he oversaw equity capital markets, corporate finance, online brokerage and technology investment banking. He has a BA in Biology from Wesleyan University and an MBA from the Stern School of Business.

Edward Kim is COO of IssuWorks. Ed has over 25 years of capital markets, finance, product development, and operations experience. Prior to helping form IssuWorks, he ran financial communications at Stern And Company, a strategic communications and public relations firm. Ed was formerly head of new products for the corporate client group at The NASDAQ Stock Market. Ed has worked in investment banking, trading, research and equity capital markets at firms including Lehman Brothers, Prudential Securities, and Robertson Stephens. He has a BS in Materials Science and Engineering from the Massachusetts Institute of Technology.