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# SEC Advisory Committee On Small And Emerging Companies Explores Venture Exchanges, Private And Secondary Securities Trading and The NASAA Coordinated Review Program- Part I

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

The SEC Advisory Committee on Small and Emerging Companies (the "Advisory Committee") was organized by the SEC to provide advice on SEC rules, regulations and policies regarding "its mission of protecting investors, maintaining fair, orderly and efficient markets and facilitating capital formation" as related to "(i) capital raising by emerging privately held small businesses and publicly traded companies with less than $250 million in public market capitalization; (ii) trading in the securities of such businesses and companies; and (iii) public reporting and corporate governance requirements to which such businesses and companies are subject."

As previously written about, on March 4, 2015, the committee met and finalized its recommendation to the SEC regarding the definition of "accredited investor." My blog on those recommendations can be read HERE. In addition to finalizing the accredited investor definition recommendation, at the March 4 meeting the Advisory Committee listened to presentations regarding and discussed several important and timely small business initiatives.

I've had the pleasure of being interviewed by committee member Sonia Luna and getting to know her as a professional. The interview can be heard HERE.

The Advisory Committee is made up of smart, engaged professionals that are committed to making the most of their role and time spent as committee members. In this blog, I will begin to summarize the topics that are of current importance to the Advisory Committee and SEC that directly affect the small and emerging company marketplace and regulatory landscape, including the U.S.'s need for venture exchanges, secondary trading developments, market infrastructure for private and unregistered securities and the NASAA coordinated review program. In this Part I, I will discuss venture exchanges.

Venture Exchanges

The topic of venture exchanges and small-cap companies is of particular importance to me and my clients – it is the world we in which we participate. This is a brief introduction to the topic, which I will explore in depth in future blogs. I have separately been writing a series summarizing recent testimony to Congress by SEC representatives. In the next blog in that series I will be summarizing the testimony of Stephen Luparello, Director of the Division of Trading and Markets, on the topic of "Venture Exchanges and Small-Cap Companies" as a continuation of this very important topic.

The creation of a legislative-supported venture exchange would be a monumental change and benefit to the U.S. capital markets. The SEC and the small-cap marketplace unanimously support the need for venture exchanges focused on the listing and trading of stocks in smaller companies and which facilitate capital formation for such companies. Current regulations on trading commissions, together with the costs associated with the necessary increased compliance for small-cap and penny stock trading, have created an environment where investment banking firms will not underwrite IPO or secondary offerings and broker-dealers will not actively make markets or recommend trading or private research in these small-cap companies.

The SEC has been exploring potential rules, regulations and structures for venture exchanges. In that regard, at its March 4 meeting, the Advisory Committee heard a presentation from David Weild IV of Issu Works and Weild & Co, an investment banking firm and potential venture exchange developer. Mr. Weild is also the previous Vice Chairman of NASDAQ and a drafter and prominent supporter of the JOBS Act. Mr. Weild's presentation was based on an article titled "The U.S. Need for Venture Exchanges," authored by Mr. Weild and Edward Kim, which is summarized herein.

A designated venture market would be one for small-cap companies, which would allow for higher brokerage and trading commissions and larger tick size to incentivize brokers and investment firms to create the compliance structure necessary to support small-cap companies, through trading, market making, research and underwriting. In addition, a venture exchange would support small-cap companies through relatively low-cost disclosure obligations and marketing efforts such as designated research analysts and a news service.

It is important to the U.S. economy as a whole to support small company IPO's and public trading. Small companies generate the largest number of new U.S. jobs per year, by a very wide margin. Small companies that grow through capital formation generate more jobs than those that grow organically from sales. As small companies carry the highest risk, investors are more willing to invest in a small company that offers a public trading market exit strategy.

To the contrary, merger and acquisition strategies and exits usually result in the loss of jobs as the joined entities eliminate duplicate administrative and other functions and close down underperforming or less profitable divisions. In today's market the big board companies, such as those on the NYSE, regularly engage in a merger and acquisition strategy followed by leaning of costs through job reductions to satisfy shareholder pressure for higher earnings. Also in today's market, as a result of the lack of a supported venture exchange, most venture capital funded small companies exit through a merger or acquisition and not through a going public transaction such as an IPO.

Statistics reveal a weak U.S. IPO market, even though the number of IPO's in 2014 was the best in 14 years. According to Weild's article (which in turn cites a Grant Thornton study) there were 284 operating company IPO's in 2014, which is far below the 360 new listings it takes for the U.S. stock markets to break even and the 520 IPO's it takes to keep up with 3% GDP rates. Additional discouraging statistics in Weild's article include that in 1994 there were 162 investment banking firms acting as a bookrunner for small IPO's (less than $50 million) and today only 34 of those firms remain in existence. In 2014 only 31 investment banks acted as bookrunner for small IPO's.

As explained by Weild, the trading markets for small- and large-cap stocks work completely differently. Small-cap stocks lack visibility (no analysts, no coverage on mainstream news sources, and generally no recommendations or solicitations by brokers) and therefore lack a following and liquidity. In addition, in small-cap stocks with low liquidity there is generally a lopsided supply and demand, with one or the other being dynamic at any given time. Large-cap companies, on the other hand, are known for low-cost, high-frequency trading, index funds and computer-based trading.

Today there are only approximately 5,000 exchange listed companies, down from 9,000 in 1997. Weild's article specifically points to the Order Handling Rules in 1997, Regulation ATS (Alternative Trading System) in 1998, Decimalization in 2001, Sarbanes-Oxley in 2002 and Regulation NMS (National Market System) in 2006 for causing the decline and costing Americans millions of jobs. Personally, I also think that the high cost of blue sky compliance and lack of greater federal pre-emption also play a substantial role.

Weild points out that prior to 1997, NASDAQ was a small-cap exchange owned by FINRA, which in turn was owned by member firms, and that stock trading at that time was quoted by member firms and not electronic. In the early days, NASDAQ market makers would ride the phone or advertise a quote. The market maker was not bound to execute at the advertised quote, such that if the market declined they could back away or if it increased they could up their bid. Today quotes are electronic and can be immediately executed upon, so the market maker has to be sure it is willing to execute at any published quote. Moreover, historically there were large tick sizes and spreads, which left room for a market maker to make a profit especially through institutional block sales or purchases. Market makers had incentive to create liquidity. Today, NASDAQ, like other big exchanges, is a privately held for-profit corporation with a primary objective of growing its own shareholder value, an ecosystem not conducive to small-cap companies, entrepreneurs or small investment banks.

Although there were flaws with the system, the idea of small-cap market support was prevalent. The enactment of Regulation ATS in 1998 reduced tick size from 25 cents per share to 3.125 cents per share, thereby eliminating large profits in the spread. At the same time, electronic self-directed online trading became prevalent and potential brokerage commissions were vastly reduced (according to Weild, these two factors alone reduced the potential profit on a $50M IPO to a third of its pre-1998 figure). The issue is simple: intermediaries and market makers are necessary to market small-cap stocks to investors and without a profit incentive, they will not do so.

In fact, in today's market not only has the profit incentive for market makers been removed, but the risks and regulatory disincentive have increased more than ever. Small-cap stocks are left to day traders riding a message board to create small changes in trading price, and are preyed upon by short-term stock promotion efforts that are often illegal.

One of the largest impediments to small-cap support is the regulatory viewpoint that low-cost trade execution is of primary importance in U.S. capital markets. Weild illustrates the flaw in their thinking. According to Weild, "[B]est 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."

Weild's Recommendations for Venture Exchanges

Weild recommends a public venture exchange (or more than one) and one or more private market venture exchanges. Weild broke down his recommendations into digestible categories, as follows:

a) Governance – Venture exchanges should have a distinct and separate set of SEC rules and regulations (e.g., regulation venture exchange). The venture exchanges should be member-owned exchanges to eliminate the competition between the exchange and value providers (brokers, analysts, etc.) inherent with a for-profit exchange. The owner members should be broker-dealers who can receive capital calls in line with their size and have representation on the board of directors.

The SEC should create a separate Venture Exchange Division staffed with financial professionals and lawyers who are required to "nurture a revival in small IPOs." The division would also be responsible for ensuring a balance of interests among the exchanges themselves, the issuers, intermediaries (broker-dealers, analysts, marketing professionals) and investors.

The Exchange Rules should include listing rules, trading rules, disclosure rules and the use of shelf registrations for capital formation. Weild likes the Reg A+ disclosure model in this regard. I agree. The rules and forms have been drafted and can and should be used across different platforms. Weild also points out that venture exchanges should be exempt from the Order Handling Rules; Regulation ATS; Regulation NMS; Unlisted Trading Privileges, Decimalization rules; Sarbanes-Oxley and state blue sky rules.

As for enforcement initiatives, Weild lobbies for a shift to prioritize enforcement over prevention. The SEC's push to prevent sales abuses has all but "gutted the capital formation engine and source of economic renewal for the entire U.S. economy." Admittedly rules that incentivize research, sales and trading will also increase sales abuses, including pump-and-dump schemes. However, Weild advocates fierce and swift action against abuses over prophylactic measures. As mentioned in my conclusion, I also believe that the current prophylactic measures have the unintended consequence of actually encouraging short-term bad behavior.

Weild advocates against ETF's and index funds which leave many small-cap issuers out of the basket and with no trading volume or broker-dealer interest.

b) FINRA and DTCC – To support the new venture exchange ecosystem, separate divisions will need to be created within FINRA and DTCC. DTCC should be required to provide electronic settlement services to venture exchange listed stocks. Broker-dealers should be allowed to solicit and recommend all venture exchange listed stocks. Margin should be allowed for venture exchange traders (but also see Weild's recommendation of full disclosure of short positions, discussed below). Broker-dealers should be required to "hard locate" shares to borrow before shorting any stock with a hard 24-hour buy-in rule.

c) Economics – Sales and marketing support, equity research coverage and market making that includes using capital and going at risk are necessary to the venture exchange ecosystem. Accordingly, higher commissions, higher tick sizes and trading spreads must be allowed. Stocks up to $2 billion in value should be allowed to list on the venture exchanges. The profit of the intermediaries should carry much more importance than the profit of the exchange itself as it is the intermediaries that will drive the success of the venture exchange listed companies.

Weild also advocates extending the Title I JOBS Act research rules to all venture exchange listed companies. Investment bankers should be able to arrange analysts' communications with investors. Analysts should be allowed to join investment banking meetings with company management and participate in road shows. Research on venture exchange listed companies should be allowed before and after any IPO or secondary offering. Liability for research published before an IPO should be limited. Moreover, the definition of research should be clarified and narrowed so that publications that do not include price targets or specific buy, sell or hold recommendations are excluded from the definition.

Short Position Disclosure – Finally, Weild advocates that the SEC require the disclosure of all short positions. Weild's arguments related to the disclosure of short positions are right on point. Corporate management have the right to decline meetings and otherwise not spend valuable time and resources dealing with investors with short positions (i.e., investors that are betting on a stock decline and therefore do not have the best interest of the other investors or company as a whole in mind). Without knowing who those investors are, management can be tricked into wasting resources. Moreover, short traders tend to post anonymous rumors and other false information on message boards and otherwise take covert negative action to push down a stock price. Requiring disclosure of all short holders would eliminate some of this underhanded (and, from my view, fraudulent) activity. Per Weild, "[W]e believe that the lack of disclosure around short-selling undermines investor confidence and the rights of corporate issuers." I believe the same.

Weild's Recommendations for Private Market Venture Exchanges

Weild believes that to really improve the entire U.S. capital markets and small-cap marketplace, both public and private market venture exchanges will be necessary (I agree). According to Weild's article, a private market exchange should include (i) basic disclosure of annual unaudited financial statements for any company that has raised over $1 million from outside investors; (ii) a consolidated tape with all secondary trading activity; (iii) the freedom to solicit accredited investors; and (iv) state blue sky law pre-emption.

Conclusion

As a voracious reader and writer on all things securities and small-cap markets, it is a pleasure to read the thought-out strategy for real change that could actually make a foundational transformation in the system and again support the small-cap marketplace and American small business growth. Weild helped create and pass the JOBS Act and has the ear of the SEC, and the SEC itself is testifying to Congress about the need for venture exchanges; this is not just fantasy or fiction.

The OTCQB quotation level of OTC Markets is attempting to publicly position itself to be America's venture exchange; however, it is doing so without the legislative foundation that would be needed to successfully attract support from investment bankers necessary for research, IPO and after-market support. From my own 22 years of experience in the industry, it is clear that the market value and trading of stocks on the over-the-counter marketplace lack an observable correlation to underlying value and are therefore not easily subjected to analytical algorithms. Investment banking houses and research analysts would need to expend man-hours to support these stocks, and need economic incentive to do so. Accordingly, a small-cap venture exchange would need to change the low-cost trading model to allow profitability by small investment banking firms and broker-dealers who, in turn, would support analytics, research and market making in these small companies.

Moreover, and as a closing note, it is my belief that the system which makes it extremely difficult for a small company to go public or sustain liquidity and a growth trading market, in and of itself, encourages the fraud and bad actors that the SEC and regulators are so anxious to prevent. Where the chance of real and sustainable value is minimized, the opportunity for manufactured short-term gains is maximized and in an unintended (and certainly undesired) consequence, short-term (pump-and-dump) fraud is encouraged.

The JOBS Act was a first step in real small-cap support; now it is time to take the second step and create a real U.S. venture exchange.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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