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Hearing on market structure: Ensuring orderly, efficient, innovative and competitive markets for issuers and investors

Statement of David Weild, Senior Advisor — Grant Thornton LLP
before the U.S. House of Representatives Financial Services Committee
Capital Markets and Government Sponsored Entities Subcommittee
June 20, 2012

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Introduction

Chairman Garrett, Ranking Member Waters and members of the Subcommittee, thank you for inviting me to speak today about an issue of great importance to many Americans: how to structure stock markets to better support the U.S. economy and job growth.

My name is David Weild. I oversee the Capital Markets Group of Grant Thornton LLP, one of the six global audit, tax and advisory organizations. I was formerly vice chairman of The NASDAQ Stock Market with responsibility for all of its listed companies, and I ran the equity new issues business of a major investment bank for many years.

Grant Thornton's Capital Markets Group provides support to companies accessing today's global capital markets. These companies run the gamut from private companies and entrepreneurs to venture capital and private equity-backed companies — both small and large.

Summary

The current U.S. market structure fails to support the needs of small and mid-sized companies that are critical to U.S. economic success. The information I present today demonstrates the following key structural challenges that the U.S. public stock markets must confront in order to foster the growth of small companies and, thus, the economy:

1. Inadequate tick sizes (the smallest increment by which a stock can be bought or sold) have eroded the economic infrastructure required to support small cap stocks. Inadequate tick sizes leave insufficient revenue to pay for needed visibility (research and sales) and liquidity (capital commitment) that support investment in small capitalization stocks once they are public. Fewer IPOs means fewer U.S. jobs. We now have a stock market that covers the cost of trade-execution services only.

2. We estimate that had the Order Handling Rules, Regulation ATS, Decimalization and Regulation NMS not been applied unilaterally to companies of all sizes:
   a. instead of averaging 128 IPOs per year in the U.S. since the year 2000, we would be averaging between 500 and 1,000 IPOs per year;
   b. instead of shrinking the number of listed companies on our stock markets, we would be growing our stock markets significantly; and
   c. the United States would have created millions — possibly over 10 million — new jobs.

3. We also believe that inadequate tick sizes have undermined Wall Street's fundamental ability to properly execute IPOs. The evidence is that while companies that go public today are much more mature than they were in the 1990s, IPOs fail at increasingly higher rates. More deals are being withdrawn, more deals are being priced below their initial filing range, and more deals are trading below their IPO price.

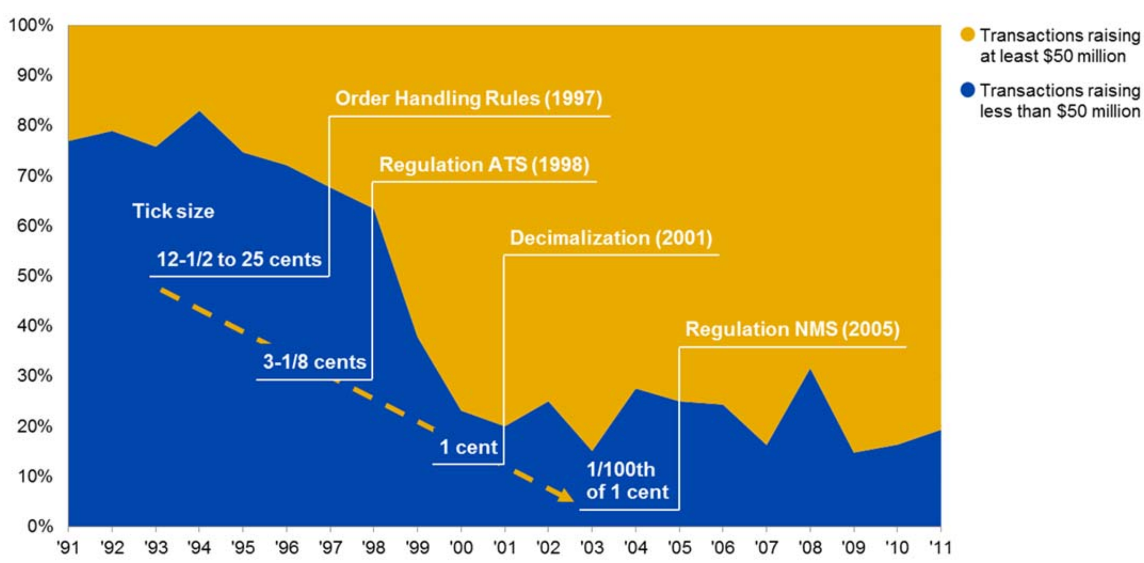
4. Finally, U.S. stock market structure is clearly optimized for trading big brand and large cap stocks. This structure encourages computerized trading and speculation at the expense of fundamental investment. It does not create essential visibility for small cap companies and those companies that lack natural brand-driven visibility. There is ample rationale for treating small company stocks differently and allowing issuers to choose their own tick size within a certain range — say, 1 cent to 25 cents per share — to encourage support for their stock. Providing better economic incentives to support small cap stocks **will** lead to increased IPOs and, in turn, higher rates of capital formation and job growth at both already-public companies and private companies.

The trouble with tiny ticks

Not so long ago, during the decades of the '70s, '80s and '90s, America's stock markets were envied by economies across the globe for their ability to birth entire new industries — such as the semiconductor, biotechnology and the personal computer industries — and to propel American leadership and economic growth in those industries.

Since 1997, the U.S. stock market has suffered a devastating decline in the numbers of small initial public offerings, a result of SEC-implemented regulations that put in motion a decade-long erosion of the U.S. capital formation and support infrastructure on which small companies relied. (Notably, the drastic drop in small company IPOs occurred ***before*** 2002's Sarbanes-Oxley Act.) While they were meant to reduce costs for investors, their unintended repercussions are significant: decreasing numbers of small-company IPOs, increased management burden of being a public company — shifting management's focus from running the business to trying to market their stock, and a one-size-fits-all U.S. stock market where only big brands can sustain adequate visibility with investors.

Order Handling Rules (1997), Regulation ATS (Alternative Trading Systems) (1998), Decimalization (2001), and Regulation NMS (National Market System) (2005) caused a collapse in effective tick sizes



Sources: Grant Thornton LLP, Capital Markets Advisory Partners, Dealogic
Data includes corporate IPOs as of Dec. 31, 2011, excluding funds, REITs, SPACs and LPs

From 1991 to 1997, there were 2,990 small-company IPOs — representing nearly 80% of all U.S. IPOs, as shown in the chart above. Tick sizes during this timeframe were largely in 25- and 12.5-cent increments. Compare this to the period from 2001 to 2007 when effective tick sizes were cut as much as 96% — from 25 cents in the early '90s to 1 cent per share by 2011. It is not a coincidence that **small-company IPO volume fell by 92%** and now represents only 20% of total U.S. IPOs. Small tick sizes eliminate the economic incentive for Wall Street firms to maintain the visibility and liquidity in small cap stocks.

The collapse in tick sizes significantly changed the stock market structure that paid for the "infrastructure" of small broker dealers, research analysts and capital support required to take small companies public and to support them in the aftermarket (once they were public). This infrastructure is analogous to the system of highways — with roads, on-ramps, bridges, tunnels and tolls — required to support commerce.

Economic infrastructure supporting U.S. capital markets	
Stakeholders: • **Roads** — Trade execution venues, such as NYSE, NASDAQ, Direct Edge, Liquidnet • **On-ramps** — Investment banks • **Bridges** — Market makers (firms ready to buy/sell stocks continually) committing capital • **Tunnels** — Analyst and broker support to investors	**Economic incentives:** • **Tolls** — Tick sizes and commissions that support the market's operations and upkeep

Since 2001, 1-cent tick sizes no longer sustain the traditional market structure that helped many small companies issue IPOs. We have let our bridges, roads and tunnels of capital formation fall into disrepair through a lack of capital investment to sustain the infrastructure.

Investment banks acting as primary underwriters (or bookrunners) today **lose** money supporting small-company IPOs after they go public. Many investment banks got out of the book-run IPO business from 1994 to 2006 — a decrease of 77% to only 39 firms in 2006. Commissions decreased 96%, and the remaining investment banks dramatically cut capital commitments for small-company stocks — eliminating stock brokers and cutting the depth and breadth of research coverage offered to investors. Many small companies were delisted from exchanges, and today, weak capital commitment from investment banks remains a serious impediment to small business accessing U.S. capital markets.

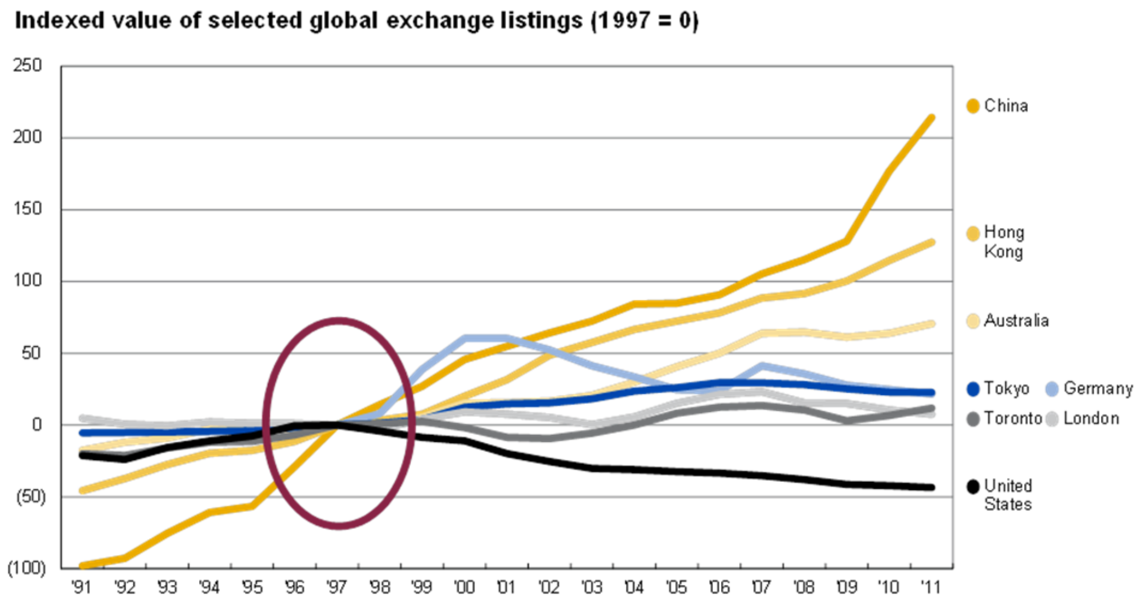
Small capitalization companies and capital formation

	Before 1997	After 2001	% change
Tick sizes	**$0.25 per share**	**$0.01 per share**	**-96%**
Investment banks (acting as bookrunner)	**167** (1994)	**39** (2006)	**-77%**
Small company IPOs	**2,990** (1991-1997)	**233** (2001-2007)	**-92%**

Small companies need salesmen, traders and analysts to create liquidity for their securities, but today, computers have taken the place of these people, thereby decreasing the visibility of small cap stocks.

Continuous decrease in IPO listings

The current market structure has increased the burdens on management and, we believe, likely elevated their cost of capital while shutting the door to the IPO market. As a consequence, since 1997 the number of listed companies has declined every year, and the U.S. has now lost 43.5% of all listed companies. Our markets will continue to shrink unless we increase the incentives to support companies in the aftermarket.



Sources: Capital Markets Advisory Partners LLC and World Federation of Exchanges
Based on the number of listed companies at year-end, excludes funds. Data as of Dec. 31, 2011.

U.S. capacity to generate new listings is also well below replacement needs to support economic growth and job creation. In fact, since 2002 it takes an average of 340 new listings just to replace what is being lost every year through the combination of mergers and acquisitions and regulatory delistings — and the U.S. has not had 340 or more listings in any one year since the 1990s.

NYSE and NASDAQ											
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Average
Net change in listings	(483)	(427)	(80)	(114)	(95)	(166)	(232)	(293)	(84)	(107)	**(208)**
IPOs	76	73	207	188	189	213	35	61	153	119	**131**
Replacement level	559	500	287	302	284	379	267	354	237	226	**340**

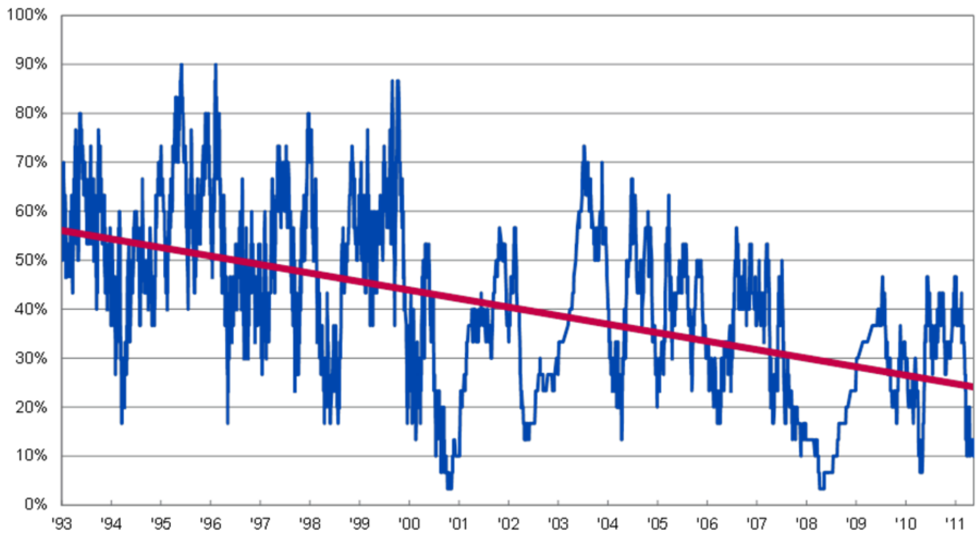
Source: Capital Markets Advisory Partners LLC

Inadequate tick sizes have undermined Wall Street's fundamental ability to properly execute IPOs

The current U.S. capital markets structure is failing all issuers, not just small businesses. Companies that are accessing the IPO market today are fewer in number and much more mature than they were in the

1980s and 1990s, but as illustrated in the charts below, IPO success rates have been in steady decline for the last 15-plus years. More deals are being withdrawn, more deals are being priced below their initial filing range, and more deals are trading below their IPO price.

Success rate of all IPOs



Source: Capital Markets Advisory Partners LLC, All rights reserved
Includes only corporate issuers, excluding funds, MLPs, SPACs and REITs.
Based on the average success rate of the last 30 filed deals, up to one year ago. A successful deal is defined as 1) priced within one year of filing, 2) priced at or above the low end of the filing range and 3) trading at or above issue price one month after pricing.

While most of our discussions have been around the adverse effects of market structure on small companies, large-cap IPOs are also showing signs of stress. Even large IPOs like Facebook are breaking issue price more often in today's market.

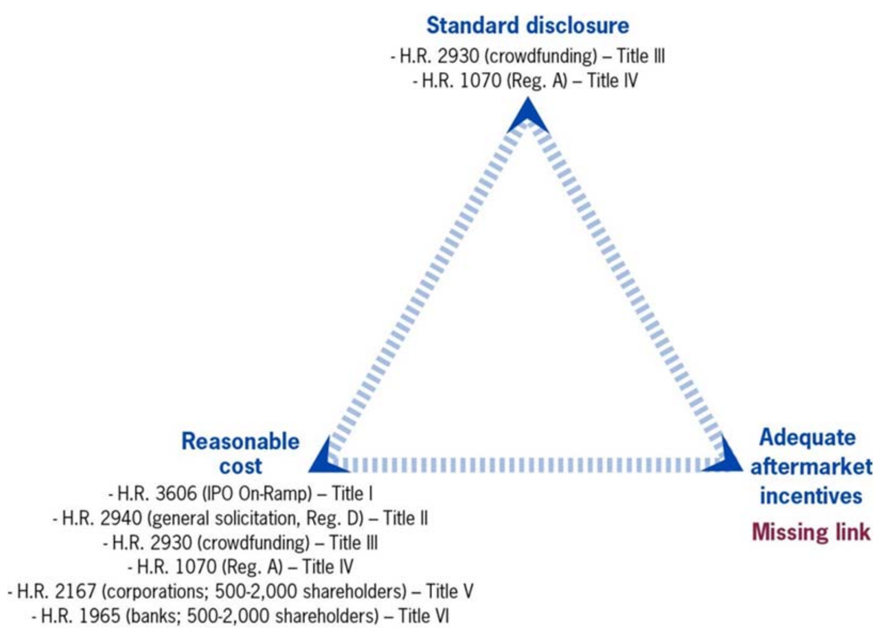
Success rate of IPOs with proceeds greater than $500 million

Source: Capital Markets Advisory Partners LLC, All rights reserved
Includes only corporate issuers, excluding funds, MLPs, SPACs and REITs.
Based on the average success rate of the last 30 filed deals, up to one year ago. A successful deal is defined as 1) priced within one year of filing, 2) priced at or above the low end of the filing range and 3) trading at or above issue price one month after pricing.

Aftermarket support: biggest obstacle to resurgence in the IPO market

Markets and small companies need to meet three criteria to thrive. Any market lacking any one of these three criteria will not live up to its potential:

1. **Standard disclosure:** Does the market provide transparency and standard disclosure?
2. **Reasonable cost:** Are the costs issuers bear to access and be in this market reasonable?
3. **Adequate aftermarket incentives:** Are there adequate aftermarket incentives to support visibility and liquidity?



The above chart maps Titles I through VI of the JOBS Act to our understanding of how each of these Titles will improve capital formation. Aftermarket support is the biggest obstacle blocking resurgence in the U.S. IPO market. Today's public markets are overly complex and do not behave in a manner that the average retail investor understands. Without adequate economic incentives, investment banks cannot afford to compensate the salesmen, traders and research analysts who can provide greater transparency to investors regarding small company stocks. Instead of supporting all company sizes, U.S. market structure is optimized for trading (not investing) primarily in S&P 500 stocks, one of the many "winners" resulting from the aforementioned regulatory changes. Our conclusion is that more needs to be done in addition to the JOBS Act to improve aftermarket support, which we believe is (based on the 1998 drop-off in tick sizes) by far the biggest obstacle to resurgence in the IPO market and resultant job growth.

Winners		Losers	
• Speculators • Big investment banks • Hedge funds • Day traders • Electronic trading • Volatility	• Trading-oriented institutions • Dark pools • Expert networks • Big company acquirers	• Small companies • Entrepreneurs • Small investment banks • Venture capital • Market-makers • Stockbrokers (advice)	• Equity research • IPOs • Liquidity in small cap stocks • Transparency in small cap stocks • Long-term investors • U.S. economy and jobs

In an economy the size of the United States', all issuers should be offered a choice in how the market trades their stock. Because of Regulation NMS, an issuer's stock is traded in only one way — the computerized, high-frequency, dark pool way.

Tick size choice for issuers

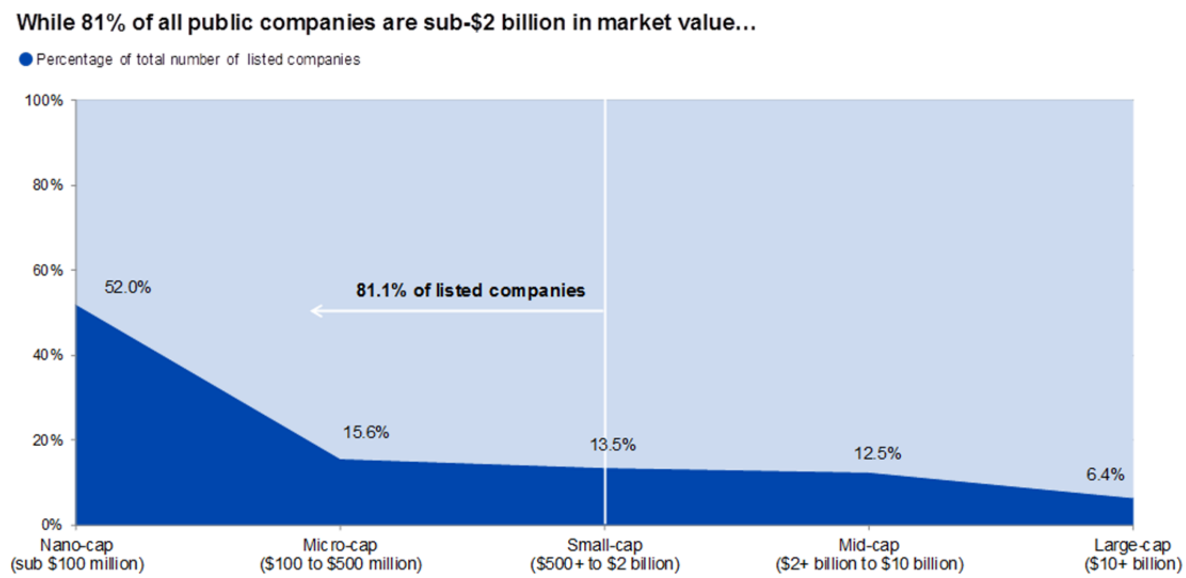
We commend Congress for its bipartisanship in passing the JOBS Act and paving the way for improved capital formation. It is a good first step, but even Congress recognized the need for greater insight and analysis of U.S. market structure, specifically instructing the SEC to study the impact of decimalization on (1) the number of IPOs, and (2) liquidity for small and middle capitalization company securities. Following the study, the SEC is allowed to set a minimum trading increment (1 to 10 cents) if it is determined that "emerging growth companies" should be traded and quoted at an increment greater than 1 cent.

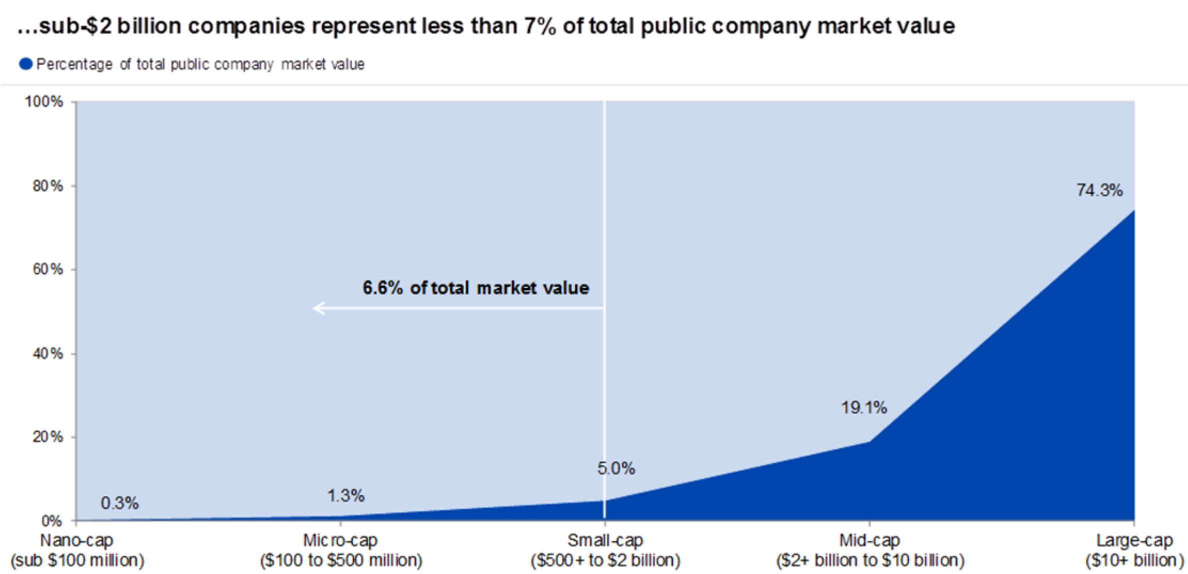
We recommend that the SEC also initiate a pilot program to let emerging growth and other small cap companies choose their own tick size, preferably between 1 cent and 25 cents (although the SEC must take care not to let trading rebates within the spread undermine the intent to pay for needed sales, research and capital commitment), following parameters determined by the SEC. We believe that managements and their boards must have input into market structure and the impact on shareholders, and an equal voice to balance that of the trading community. What better way to do this than to give issuers control over their own tick size?

During this pilot program, the SEC could also gather valuable research and data to inform the debate on how to best structure the U.S. capital markets to support capital formation and job growth. **The SEC could evaluate the impact of different tick sizes on the pricing and trading patterns of emerging growth and small cap companies, and track variances across specific industries and company sizes.** These, among other areas of study, would help define optimum tick sizes to keep costs low for investors and attract the necessary infrastructure support. Market forces would then become the determinant of tick sizes, and small companies would no longer be adversely affected by a one-size-fits-all market structure.

Since today's investment banks lose money supporting most IPOs in the aftermarket, increasing aftermarket incentives is required to fuel investments in equity distribution, sales and aftermarket support for small public companies. Increases in tick sizes would create instant mass customization of stock markets and their choices. Markets would also realign and refocus distribution on investors, not traders, and improve the performance of IPO shares and investor returns — all while laying a foundation for increased IPOs, economic growth and job creation.

Small-, micro- and nano-cap listed companies represent only 6.6% of cumulative market value, yet they represent fully 80% of all publicly listed companies. Thus, as a public policy matter, there is ample rationale for treating small company stocks differently and allowing issuers to choose — by setting their own tick size — how the market trades their stock.





Sources: Grant Thornton LLP and Capital IQ
Includes NASDAQ, NYSE (including AMEX) and OTC listings. Corporate issuers only, excluding holding companies, funds, MLPs, SPACs, REITs and other trusts.

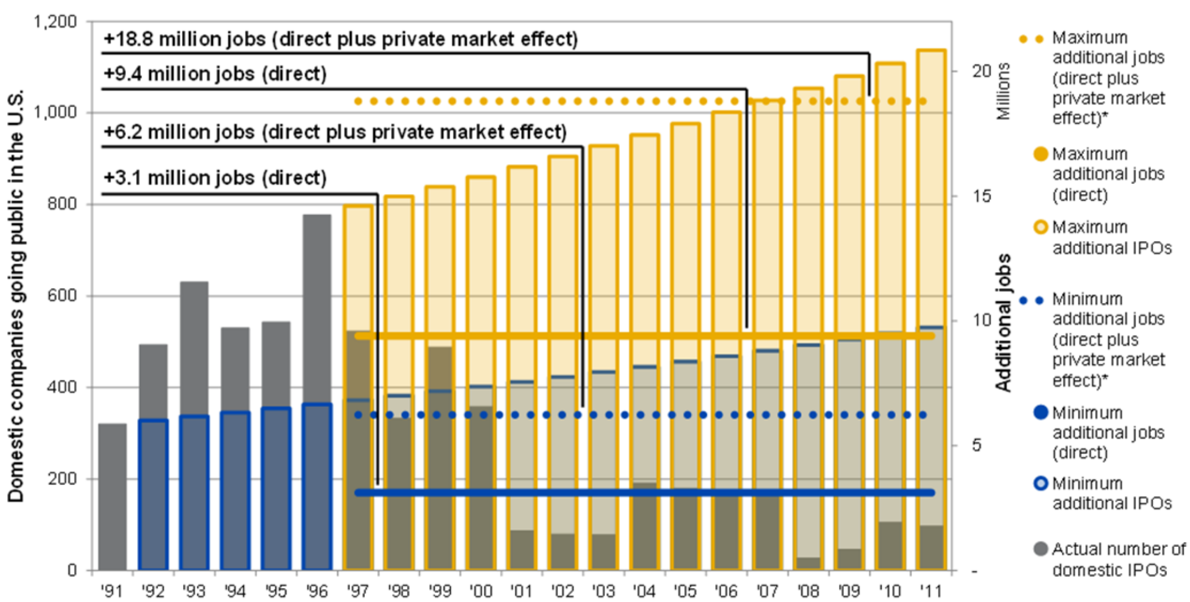
Conclusion: IPOs lead to job growth

Efficient markets need to do more than create rock-bottom trading costs for market speculators. Markets also need to improve the allocation of capital and enhance long-term economic growth. When today's companies cannot raise capital effectively through the IPO market, they must look to a merger or acquisition — and jobs are lost, not gained.

An opportunity cost of millions of jobs and untapped economic growth for the U.S. economy

According to the graphic below, had the Order Handling Rules, Regulation ATS, Decimalization and Regulation NMS not been applied unilaterally to companies of all sizes, the U.S. market could have generated between 500 and 1,000 IPOs a year — this versus the paltry 128 IPOs per year that we have averaged since 2000.

A major contributor to employment



*Best estimate of the multiplier effect in the private market of more companies going public

Sources: Grant Thornton LLP, Dealogic and the U.S. Department of Commerce Bureau of Economic Analysis
Domestic corporate companies going public in the U.S. as of Dec. 31, 2011, excluding funds, REITs and other trusts, SPACs and LPs.
Assumes an annual growth rate of 2.57% (U.S. real GDP growth, 1991-2011) and 822 jobs created on average post-IPO (see "Post-IPO Employment and Revenue Growth for U.S. IPOs," *Kauffman Foundation*).

Back in 1971, there was a small technology company that was unprofitable on an operating basis. It was only three years old when it went public, raising roughly $8 million — approximately $44 million in today's dollars. It created a revolutionary product: the first commercially available microprocessor chip. After it went public, it actually missed its first delivery date and investors cut its stock price in half. Talk about risk! That kind of company wouldn't even make it to the IPO stage in today's unforgiving market.

The name of that company? Intel. How many Intels have been needlessly lost to the U.S. economy by today's market structure?

Congress has the power to help reverse our current situation and bring back the stock market that was once the envy of economies throughout the world for its ability to foster U.S. economic leadership. We recommend that Congress support an SEC pilot program that allows emerging growth companies and other already-public, small capitalization companies to customize their tick sizes.

Thank you for the opportunity to present information on such an important topic. I am pleased to answer any of your questions.

Additional materials

June 8, 2012, presentation to SEC's Advisory Committee on Small and Emerging Companies

Why are IPOs in the ICU?

Market structure is causing the IPO crisis — and more

A wake-up call for America

Wall Street Journal OpEd entitled, **"How to revive small-cap IPOs,"** October 27, 2011

About David Weild

David Weild is a Senior Advisor to Grant Thornton LLP's Capital Markets Group, which provides strategies and insights into today's global capital markets.

Experience

David is the Chairman & CEO of Capital Markets Advisory Partners and the former vice-chairman and executive vice-president of The NASDAQ Stock Market, with oversight of the more than 4,000 listed companies. Prior to NASDAQ, he spent 14 years at Prudential Securities in a number of senior management roles, including president of eCommerce, head of corporate finance, head of technology investment banking and head of equity capital markets in New York, London and Tokyo. He worked on more than 1,000 IPOs, follow-on offerings and convertible transactions and was an innovator of new issue systems and securities underwriting structures, including the use of Form S-3s to mitigate risk for small capitalization companies raising equity and convertible debt capital. He created the Market Intelligence Desk — or "MID" — while at NASDAQ to support issuers in their quest to better understand what was impacting trading in their stocks.

Education

David holds an MBA from the Stern School of Business and a BA from Wesleyan University. He has studied on exchange at The Sorbonne, Ecole des Haute Etudes Commerciales and The Stockholm School of Economics.

Industry participation

David has participated in the NYSE's and National Venture Capital Association's Blue Ribbon Regional Task Force to explore ways to help restore a vibrant IPO market and keep innovation flourishing in the United States, and is Chairman of the International Stock Exchange Executives Emeriti (ISEEE) Small Business Financing Crisis Task Force. He served as Director of the National Investor Relations Institute's New York chapter and Helium.com (sold to RR Donnelly) and currently serves as a Director of Hanley & Associates and as Chairman of the Board of Tuesday's Children, the non-profit that serves 9/11 families, first responders and their families. David testified before the CFTC-SEC Joint Panel on Emerging Regulatory Issues in the wake of the May 2010 "flash crash," and before the SEC Advisory Committee on Small and Emerging Companies on June 8, 2012. David is often interviewed by the financial news media.

Publications

David and Edward Kim have co-authored a number of Grant Thornton studies, including *Why are IPOs in the ICU?* in 2008. Released in the fall of 2009, *Market structure is causing the IPO crisis* (updated by *Market structure is causing the IPO crisis — and more* in 2010) and *A wake-up call for America* have been entered into the Congressional Record and the Federal Register. They also authored the chapter, *Killing the Stock Market That Laid the Golden Eggs* in the recent book on high frequency and predatory practices entitled, *Broken Markets,* by Sal Arnuk & Joseph Saluzzi, published in May 2012 by FT Press (Financial Times).

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