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Arguments For And Against A Venture Exchange

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With a total of 284 U.S. operating company initial public offerings in 2014, the U.S. securities market might appear to be on an upswing — after all, this was its biggest year since the dot-com era ended in 2000. Nonetheless, this figure does not compare with what it should be given our annual 3 percent gross domestic product growth rate, which would have required 520 IPOs if the dot-com era is used as the baseline. Furthermore, the U.S. is no longer the world leader in IPOs — it has fallen to no. 2 in large IPOs and no. 12 in small IPOs, and has experienced a decrease to only 5,000 listed companies from 9,000 in 1997. The shrinking U.S. IPO market brings associated potential problems: lackluster employment opportunities, decreased innovation and failure of the U.S. to sustain itself as a market leader.

This issue is garnering attention from many legislators, regulators and commentators. Some argue that the current structure of the U.SSecurities and Exchange Commission, the Financial Industry Regulatory Authority and the U.S. stock markets creates a bias in favor of large-cap companies, making it more difficult for small-cap companies to complete a successful IPO and achieve status as a listed company. They also note that certain foreign securities markets have benefited from their legislators' recognition that small-cap stocks have fundamentally different needs than their large-cap counterparts.

One of the fixes suggested has been the creation of a "venture exchange" in the U.S. As proposed, the venture exchange would be an entirely separate public securities market chartered by the SEC that permits listings of up to $2 billion in market value. Its listed companies would be exempted from several disclosure and regulatory requirements, including certain provisions of the Sarbanes-Oxley Act, state securities acts, the Order Handling Rules, Regulation ATS and Regulation NMS. The venture exchange would be member-owned by broker-dealers and would offer higher per share market-making incentives. This "pro-growth" environment would offer scaled issuer disclosure requirements and possible after-market solicitation of accredited investors and institutions.

The concept of a venture exchange is not novel. Several variations of the venture exchange model have experienced success — and failure — in the past. The most notable former venture exchange is now the Nasdaq Stock Market. In the 1970s through the 1980s, Nasdaq was a member-owned trade reporting facility, offering a small-cap exchange environment for issuers that did not meet the

requirements of the NYSE or other "real" stock exchanges. Venture-type exchanges have also existed in other countries and include the London Stock Exchange's Alternative Investment Market and Canada's TSX Venture Exchange.

The venture exchange model is not without shortcomings. First, higher per share market-making incentives could result in "boiler room" tactics by brokers, creating a risk that investors lacking the necessary financial savvy or wherewithal will be encouraged to purchase risky investments. Second, lower listing standards could result in the wrong companies coming to market or the right companies coming to market prematurely, resulting in the eventual failure and delisting of these companies to the detriment of their stockholders.

Third, decreased disclosure and regulatory requirements could create an environment where fraud is prevalent. Finally, a venture exchange may not be a financially viable solution — over the past 80 years, over 20 regional stock exchanges have gone out of business or been forced to merge. A venture exchange might meet the same fate unless it is more thoughtfully created.

Proponents of the venture exchange assume that it is in the public interest to enable unsophisticated investors to purchase securities that would otherwise be unavailable to them. While investing in small-cap companies brings the potential for significant returns, it is not without risk — especially with respect to early-stage companies. Policymakers must consider whether it is more important to protect investors from high risk companies than to bring these companies to market.

If decision makers in the U.S. want to improve our IPO statistics, they must first identify whether the resources required to create a vibrant venture exchange could be more effectively used to remold the existing U.S. platform in a manner that would increase the number of public companies. To effect this change, existing U.S. structures and institutions must become better suited for small-cap companies through the identification and elimination of bias toward large-cap companies. Legislative and regulatory solutions to address these issues and provide relief to small-cap issuers could include:

- Requiring FINRA members to have a minimum percentage of small-cap offerings per year

- Requiring analysts to provide increased coverage of small-cap companies, thereby increasing the attention given to such issuers without increasing their marketing expenses

- Providing tax incentives to small-cap companies undergoing the IPO process, effectively reducing the cost of conducting a public offering under the current regime

It is unclear whether these alternatives would result in a more or less favorable environment for small-cap companies than the creation of a venture exchange. Nonetheless, it is time for those charged with shaping the U.S. securities markets to take some action to open the IPO process to more exciting young businesses.

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