The JOBS Act — next steps for success

Public Policy Perspective May 2012

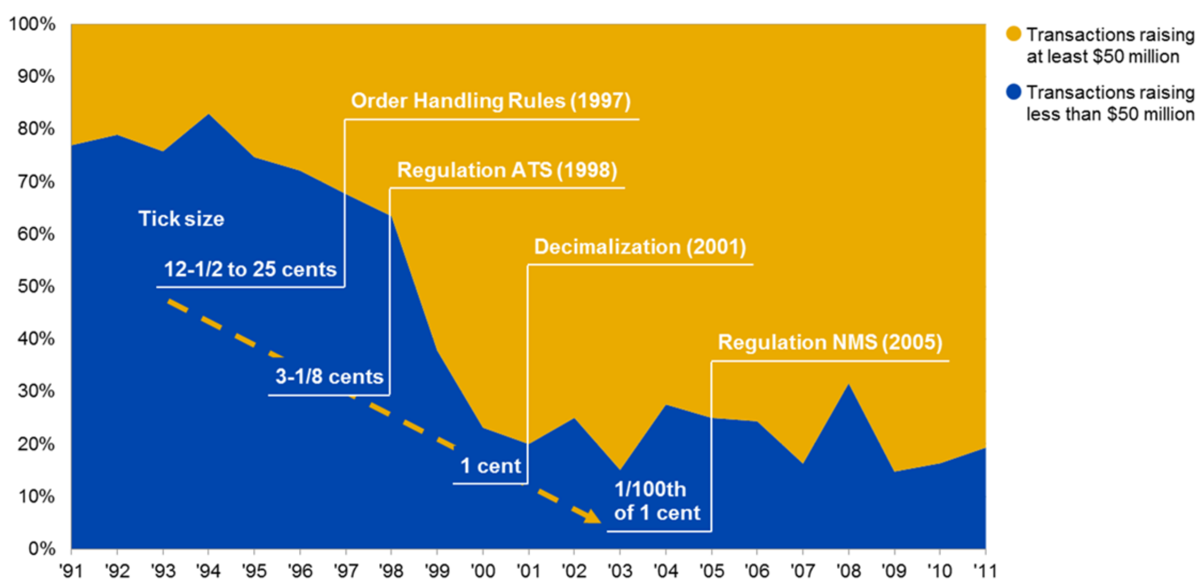
For more information, contact:

Mary Moore Hamrick
National Managing Principal
of Public Policy
T 202.521.1545
E MaryMoore.Hamrick@us.gt.com

The JOBS Act — a first step to help small businesses access U.S. capital markets

- The JOBS Act (Public Law 112-106) is an important first step to encourage small businesses to access U.S. capital markets, spur innovation, generate new jobs and revitalize the U.S. economy.
- **Small companies, however, still face a major challenge — a result of changes to U.S. stock market structure — namely, the loss of the economic incentives required to sustain interest in small cap stocks once they are public.**
- Prior to 1997, the stock market structure provided a successful framework within which many small companies accessed U.S. capital markets. From 1991 to 1997, there were 2,990 small-company IPOs — representing nearly 80% of all U.S. IPOs, as shown in the chart below. Tick sizes during this timeframe were largely in 25- and 12.5-cent increments. Compare this to the period from 2001 to 2007 when tick sizes were driven to only 1 cent per share and **small-company IPO volume fell by 92%.**

Smaller tick sizes undermined U.S. small-company IPOs



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

- After 1997, a series of SEC-implemented regulations altered the economic infrastructure on which small companies relied. As each rule was implemented, prevailing tick sizes declined, leading to a drastic drop in small-company IPOs (which, notably, occurred before 2002's Sarbanes-Oxley Act).
  - **Order Handling Rules (1997)** required dealers to provide investors with their most competitive quotes. They laid the groundwork for greater competition between dealers, which allowed tick sizes and liquidity to narrow with new regulations enacted in 1998 and 2001.
  - **Regulation Alternative Trading Systems (ATS) (1998)** allowed approved ATSs to link their securities and orders with registered exchanges. It opened traditional trading venues like NASDAQ to fierce competition by driving down the volume of orders and reducing tick sizes to 3.125 cents.
  - **Decimalization (2001)** required stocks to be quoted in decimals instead of fractions. Decimals quoting allowed a minimum tick size of 1 cent, which resulted in decreased liquidity and increased use of algorithmic trading and speculative activity.
  - **Regulation National Market System (NMS) (2005)** implemented several rules to improve U.S. exchanges, overhauling their structure. Despite prohibiting sub-penny stock quotes, the SEC allowed certain exceptions — such as dark pools (i.e., large trades that occur outside of an exchange). The exception became the rule and many more trades were executed at sub-penny increments, further cementing the erosion of trading spreads that occurred between 1997 and 2001.

Congress recognized the need for further study

- In passing the JOBS Act, 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.
- The JOBS Act also **allows the SEC to set a minimum trading increment (1 to 10 cents)** if it is determined that "emerging growth companies" (EGCs) should be traded and quoted at an increment greater than 1 cent.

> - **Decimalization:** Euphemism for the narrowing of trading spreads from fractions (quarter- and eighth-point increments) to decimals (penny and sub-penny increments).
> - **Trading spreads:** The quoted difference between the National Best Bid and Offered (NBBO) price for a stock, future or other exchange-traded instrument.
> - **Tick sizes:** The smallest increment by which a stock, future or other exchange-traded instrument can be bought or sold. "Tick size" is frequently confused with "trading spread." The smallest "tick size" is always smaller than or equal to the quoted "trading spread."

Regulations leading to smaller tick sizes have negatively impacted U.S. capital markets

While regulations were meant to reduce costs for investors, their repercussions are significant — decreasing the number of small-company IPOs, increasing the management burden of being a public company, and leaving a one-size-fits-all U.S. stock market where only big brands can sustain adequate visibility with investors.

- The U.S. IPO market has suffered a significant decline, particularly with respect to small companies. Over the period 1991 to 2001, the number of U.S. IPOs smaller than $50 million dropped from nearly 80% to 20%.
- This decline is the unforeseen consequence of the **regulations enacted between 1997 and 2001** that **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

- If tolls were cut and roads, on-ramps, bridges and tunnels were allowed to deteriorate, the cost to get goods to market would increase. Likewise, with the loss of tick sizes and commissions (or "tolls"), the stock market infrastructure has deteriorated, and public company management is left to pay the increased cost of supporting liquidity in their share prices — a burden many companies are unable to bear. The U.S. IPO market has thus retracted sharply, resulting in a shrinking economy.

U.S. stock markets must increase tick sizes to build needed support for small companies

A series of uncoordinated regulatory changes aimed at cutting transaction costs has led to a number of negatives — not only for small companies and the small broker dealers and long-term investors that supported them, but also for the U.S. economy.

- **Decimalization and the corresponding drop in tick sizes from 25 cents to 1 cent (and even sub-pennies) caused** a gradual collapse in the infrastructure small companies need to access public markets.
  - **Loss of profits to pay for research, sales and trading support** — Since 2001, 1-cent tick sizes no longer sustain the traditional market structure that helped many small companies issue IPOs. Investment banks acting as primary underwriters (or bookrunners) today lose money supporting small-company IPOs after they go public.

    Tick sizes decreased 96%, and 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. 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%**

  - **Market-makers have been replaced by high-frequency traders that focus on large, high-volume stocks** — Only companies with high visibility — like Facebook and LinkedIn — whose brands create demand for their shares can survive without research, sales and trading support. After decimalization, Wall Street was forced away from serving investors in growth stocks and toward an increasingly narrow subset of very large cap-oriented and high-turnover institutions and hedge funds.
- Investors now face U.S. capital markets that are more complex, opaque and volatile.
  - **Greater complexity and volatility undermine investor confidence** — The U.S. stock markets were once dominated by three stock exchanges (NYSE, NASDAQ and AMEX) that focused on investing and capital formation. The markets are now fragmented across 60 different venues focused on trading.
  - **Increase in high-frequency trading (HFT)** — Lower tick sizes have led to increased market speculation, dark pools and HFT — from approximately 10% of daily U.S. trading in 2000 to at least 60% today. Rather than supporting long-term company growth by bringing research, sales and capital to investors, HFT seeks to make a quick profit by identifying short-term price discrepancies.

Winners		Losers	
• Speculators • Big investment banks • Hedge funds • Day traders • Electronic trading • Volatility	• Trading-oriented institutions • Dark pools • Expert networks • Big company acquirers • Asia	• 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

- **U.S. capacity to generate new listings is well below replacement needs to support economic growth.** The total number of U.S.-listed companies has shrunk every year since 1997 — down 43.5% through year-end 2011 — exceeding the number of new IPOs joining U.S. exchanges. While 387 new listings annually are needed to maintain a steady number of listed companies, the U.S. has averaged only 126 IPOs per year since 2001.
  - **Lower growth —** Efficient markets improve the allocation of capital and enhance long-term economic growth. But U.S. economic growth will be inhibited by the inefficiency of U.S. stock pricing.
  - **Job loss** — When companies can't raise capital effectively through the IPO market, they must look to a merger or acquisition — and jobs are lost, not gained. In today's stock market structure, most small companies' exit strategy is not a public listing, but a merger or acquisition.

Grant Thornton's position

- **Grant Thornton supports** the JOBS Act requirement for **the SEC to study the impact of decimalization on U.S. capital markets**. The study is a first step in opening the dialogue around small-company market structure concerns.
- **We encourage the SEC** to pursue the option given it by the JOBS Act **to set higher minimum trading increments** for EGCs. While the Act only covers EGCs, **all small capitalization companies would benefit from the support created by higher tick sizes**. We believe higher tick sizes will expand research, sales and trading support to more small companies; raise the visibility of small, unknown brands to investors; and educate and expand investors' pool of investment opportunities.
- When the SEC submits its decimalization report to Congress, **we recommend** that it also seek to initiate **a pilot program to let EGCs and other small cap companies** — under the framework established by the JOBS Act — **choose their own tick size, following parameters determined by the SEC**. We believe that managements and their boards must understand the linkage between market structure and the impact on shareholders. What better way to do this than to give them control over their own tick size?
- During the 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 affected by a one-size-fits-all market structure.

What we ask of you

- **Encourage the SEC** to establish a long-term **review of small-company market structure concerns** through additional studies and oversight.
- **Support an SEC pilot program that allows EGCs and** other already-public, **small capitalization companies to customize their tick sizes**.

About Grant Thornton

The people in the independent firms of Grant Thornton International Ltd provide personalized attention and the highest quality service to public and private clients in more than 100 countries. Grant Thornton LLP is the U.S. member firm of Grant Thornton International Ltd, one of the six global audit, tax and advisory organizations. Grant Thornton International Ltd and its member firms are not a worldwide partnership, as each member firm is a separate and distinct legal entity.

In the U.S., visit Grant Thornton LLP at www.GrantThornton.com.