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The decline of the US capital markets

BY BLAKE HORNICK AND MICHAEL DUNN

There has been much speculation about the state of the United States public equity markets of late. The number of publicly traded companies listed on a US exchange is now around 5000, down from a high of approximately 8800 in 1998. There were 258 IPO filings and 154 completed IPOs in the US in 2010, down from 299 IPO filings and 214 completed IPOs in 2007. Many venture-backed companies now opt for a sale to a strategic or private equity buyer as a primary liquidity event rather than the traditional route of going public. The London, AIM, Shanghai and Hong Kong stock exchanges have become serious alternatives to going public in New York City. Rightly, this migration to foreign markets is seen as a serious problem. Why is this?

Several commentators, mostly on the right or conservative side of the political spectrum, see the reason for this exodus from the US capital markets as over-regulation. They cite Sarbanes-Oxley, particularly the mandate under Section 404(b) for outside auditor attestation as to management's statement on the effectiveness of internal controls, as evidence of this over-regulation. The SEC's April 2011 report on Section 404(b) compliance shows that since 2007, the average annual Section 404(b) compliance costs for small cap ($75-$250m), mid cap ($250-$700m) and large cap (over $700m) companies have been $840,000, $1.2m and $4m, respectively. In addition, the CEO and CFO certifications required by Sections 302 and 906 of Sarbanes-Oxley, civil and criminal certifications for which those executives are personally liable, are viewed as a negative, particularly by foreign private issuers contemplating Level II or Level III American Depositary Receipt (ADR) programs.

Such commentators also criticise certain provisions of the Dodd-Frank Act of 2010, including the say-on-pay and clawback provisions, as deterring companies from going public or staying public in the United States. Litigation costs relating to the half dozen shareholder derivative suits resulting from failed say-on-pay votes will be a burden to those companies and a deterrent to future public companies who may view second guessing of a board's exercise of its fiduciary duties as a less desirable regulatory environment compared to European or Asian market alternatives. In addition, the clawback provisions of the Dodd-Frank Act, which require disgorgement of incentive compensation to all executive level officers in the event of an accounting restatement, even if such officers were not guilty of any malfeasance or intent to defraud, will no doubt be cited by foreign exchanges in their presentations to potential IPO management teams. Lastly, several commentators, including Republican Congressman Darrell Issa, in correspondence with SEC Chair Mary Schapiro earlier this year, have been critical of provisions under the federal securities laws that require private companies with more than $10m in assets and more than 500 shareholders to register as public companies. These registration requirements are viewed as inhibiting capital formation for hot social media companies like Facebook. There is now legislation pending in Congress to liberalise these rules.

There are, however, other viewpoints. A variety of deregulatory measures in the last quarter century have made it less profitable for market participants, and consequently more difficult for companies, to consummate small to medium size IPOs and to then provide valuable after-market support to such companies. These deregulatory measures include: (i) the so-called 'May Day -1975', when the SEC deregulated the brokerage industry, abolishing fixed commissions and thereby creating opportunities for discount brokerage firms that have since flourished; (ii) the 1997 transition by the NYSE from fractions to decimals in trading and the resulting advent of electronic and online trading; (iii) the abolition of NYSE rules requiring NYSE stocks to trade first on the NYSE during the trading day; (iv) the adoption in 1997 by NASDAQ of the 'limit order display rule' requiring market makers to display investors' limit orders that are priced better than the market maker's quote and the 'quote rule' requiring market makers to publicly display their most competitive quotes; (v) the abolition of the 'open outcry' system; (vi) the 2003 global research analyst settlement separating the research and investment banking functions at firms; and (vii) the evolution of the NYSE into a public company itself after the fall of Dick Grasso.

The net effect of these changes is that the middle man and analyst profit from supporting and covering 'microcap' public companies – those with public floats between $50m and $300m, has been substantially reduced. These effects are exacerbated by FINRA regulations that limit the amount of underwriter compensation in public offerings to no more than 8 percent (including expense reimbursement) of the gross offering price. With lower margins and an 8 percent compensation cap, the market players focus their efforts on the larger gross deals, leaving many emerging microcap companies in the US markets lacking analyst following, investment banking interest or market support.

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Other developments are: (i) the growth in the sophistication of foreign stock exchanges and regulatory systems, as acknowledged by the SEC itself in its 'information supplying exemption' under Rule 12g3-2(b); (ii) the rise of foreign economies with their own companies that want their primary stock market listing to be local to them; and (iii) the explosion of the growth of the private equity industry in this country which has removed many companies from the public markets, approximately 500 in 2010 alone. In addition, recent political wrangling over the increase of the US debt ceiling against the backdrop of a weakening US dollar and ever increasing trade deficits and US national debt cast a cloud of uncertainty over the US capital markets.

It is unclear whether or how this trend will develop. It is clear, however, that steps (some re-regulatory, some de-regulatory) need to be taken to spur US capital formation. One such item would be the pending legislation to make Regulation A more available and to increase the cap for Regulation A offerings from $5m to $50m. This form of mini-registration should be encouraged, as it provides the benefits of scrutiny that registration provides without the corresponding burdens that would otherwise follow with public company reporting. Such relief would provide greater transparency to a large number of capital transactions that today are being conducted as private placements.

More ways to support the middleman are needed. FINRA has proposed a rule that would create a 15 percent cap on underwriter's compensation in private placement transactions, but perhaps a sliding scale cap between 8 and 15 percent based on the market cap of the issuer, if implemented with restrictions on the amount of the market discount in offerings, could create real incentives to provide meaningful support and investment at the microcap level.

Ultimately, ways to encourage companies to go and remain public, with regulation perhaps at a reduced level, need to be found. Reducing execution costs for day traders and highly sophisticated market participants who do not have a long term view, is not necessarily in the public interest.

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