

# **Opening The World's Equity Markets To Small, Medium Size Companies**

A Proposal Of The International Stock Exchange Executives, Emeriti, Inc. (ISEEE)

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## Executive Summary

1. The needs of small and medium enterprises (SME) to raise capital via initial public offerings (IPO) have been neglected. In the view of the members of the International Stock Exchange Executives, Emeriti (ISEEE) this is because, the behaviour of profit-oriented financial market participants across the world has shifted in response to changes in stock market regulation.
2. Thus, changes are urgently needed as SMEs produce a greater portion of gross domestic product (GDP) and more jobs in most countries than the large “Blue-Chip” companies. .
3. These changes will bring lower disclosure requirements and costs and keep markets regulated and fair.
4. Various factors outlined are forcing SME issuers to use private markets to reduce costs. This is restricting their access to risk-capital and also limiting direct investment opportunities for private individuals.
5. ISEEE members propose that securities market regulation and structure should recognise the following segments, rather than reflect a “one-size-fits-all” approach to market regulation:
  - private securities (not publicly tradable); and
  - 3 kinds of public securities;
    - publicly tradable but not quoted;
    - publicly tradable, and quoted in Small Business Markets (SBM) under the proposed “carve-out” ; and
    - publicly tradable and quoted in large traditional public markets.
6. The ISEEE members call for a proposed general “carve-out” framework to be tailored for application in any particular jurisdiction. Key elements of the framework are:

FOR	REQUIREMENT
<b>ISSUERS and SELLERS</b>	<ul style="list-style-type: none"> <li>➤ all bids and offers are public;</li> <li>➤ size limits for issuers;</li> <li>➤ market buybacks and sales of additional stock permitted;</li> <li>➤ minimum standard disclosure;</li> <li>➤ clear risk-warnings; sponsor for IPO; and</li> <li>➤ special status of startups.</li> </ul>
<b>INTERMEDIARIES</b>	<ul style="list-style-type: none"> <li>➤ licensing;</li> <li>➤ market making; and</li> <li>➤ conflicts allowed but disclosed.</li> </ul>

FOR	REQUIREMENT
<b>SECURITIES MARKET CONDUCT</b>	<ul style="list-style-type: none"> <li>➤ public rules;</li> <li>➤ participants must agree to rules;</li> <li>➤ no restrictions on investors;</li> <li>➤ trading by directors and officers with notice and pause;</li> <li>➤ naked short sales not allowed;</li> <li>➤ all ownerships transfers reported;</li> <li>➤ no restrictions on who may trade;</li> <li>➤ all disclosures public;</li> <li>➤ market makers can set spreads;</li> <li>➤ full post transaction transparency; and</li> <li>➤ proper clearing and settlement.</li> </ul>
<b>GENERAL STRUCTURE ISSUES</b>	<ul style="list-style-type: none"> <li>➤ only for public markets;</li> <li>➤ special governance requirements; and</li> <li>➤ special supervision and enforcement.</li> </ul>

## Introduction And Overview Of The ISEEE

The International Stock Exchange Executives Emeriti Inc. (ISEEE) held their first meeting in Orlando, Florida in March 2008 and created a collegial educational forum of former and current exchange officials to identify, discuss and assess the issues germane to the global community of exchanges. In December 2008 the ISEEE was incorporated as a New York State Not-For-Profit Educational Corporation.

The ISEEE seeks to:

- facilitate contact with experts in the fields of finance, regulation and technology and leverage the expertise of former senior exchange executives from major exchanges across the world;
- provide educational opportunities by sharing information on developments in areas such as market structure and regulation, listing, trading, disclosure, clearing and settlement, access to the markets, and enforcement, and investor protection; and,
- facilitate opportunities for members and guests to establish and maintain business and social relationships.

The ISEEE currently has nearly 40 member-participants from 23 countries that have been, or currently are, officials of nearly 70 stock and derivative exchanges from North and South America, Europe, Asia-Pacific, and the Middle East, as well as other authorities in the capital markets and related businesses. The By-Laws provide that members shall have been a senior

executive or had a business relationship with one of the world's recognized stock or derivative exchanges or have had, or has, a business or academic interest in the operations of stock and derivative exchanges.

Since the first ISEEE meeting in Orlando, the ISEEE has met there in each succeeding year.

Following each Annual meeting, an Orlando Declaration has been issued and distributed to the press, regulatory authorities, legislators, and other interested groups. The Orlando Declaration 2012 includes a summary of The Eleven Actions for Balanced Global Reform: On reforming market structures and improving small business financing.

In 2010 a Small Business Financing Crisis Task Force was created to formulate and suggest practical and positive steps to improve the way small and medium capital enterprises can raise equity capital and their recommendations are summarized in The Orlando Declarations. The chairman and members of the task force have testified separately before legislative and regulatory authorities suggesting actions, which are needed to improve the SME capital-raising process.

Further information about the ISEEE its members, and copies of papers presented at the meetings, may be found at [www.capitalmarketexperts.org](http://www.capitalmarketexperts.org).

## **Developments, Trends and Implications For Small And Medium Business Public Equity Financing**

The starting point for proposals to improve the access of Small and Medium sized Enterprises (SMEs)<sup>1</sup> to equity finance is the identification of the problems that need to be addressed.

David Weild<sup>2</sup>, an ISEEE member, and others, have identified the trend in the United States of reduced support for IPOs, and particularly for small business public equity capital raising. Reduced support for IPOs has also been observed by members in other developed market economies experiencing lower economic growth.

Increases in government regulation, coupled with less self-regulation, have accompanied the trend toward for-profit, competitive exchanges. This has seen regulation of the public market conduct of issuers and intermediaries, and responsibility for supervision and surveillance of markets, move to national regulators from exchanges, with increased rule-making aimed at the larger and national markets and more intervention and control by regulators. It has increased compliance costs for issuers and reduced profitability for intermediaries, resulting in a lack of essential support for SMEs raising equity finance.

Well-intentioned regulatory requirements--which force intermediary competition, reduce or eliminate conflicts, and reduce transaction margins -- are driving intermediaries to focus increasingly on highly liquid securities and to seek lower unit costs through increased size. Reduced margins have meant brokers have moved to seeking fees for supporting IPOs, rather than placing their capital at risk, thus increasing the costs of going public for smaller issuers. Reduced IPO business and smaller margins have increased the focus on proprietary trading for profitability, a move to more derivatives trading more leverage, and more asset management, and the pursuit of economies of size, with fewer, bigger brokerages.

These trends are making brokerage firms increasingly anonymous and impersonal to investors.

Pressure to please investors by being well behaved and acting in their interests is being replaced in larger organisations by pressure to satisfy shareholders and to impress and compete with peers in revenue generation. Very large publicly traded companies are focused on key shareholder responses and peer reputations. Shareholdings are concentrating in institutions as intermediaries move to more asset management. The personal community and individual peer pressure on individuals in intermediaries and issuers to behave well and act in the public interest-- lest their reputations and livelihoods be damaged-- has been overtaken by concern for rule-based compliance and legal threats, and concern for how their conduct is viewed by their close group of industry peers who share common values and interests, not how their conduct is viewed by small investors and SMEs.

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<sup>1</sup> The concept and definition of an SME varies. In this paper, although we suggest some thresholds, we are less concerned with the definition of an SME than other issues. Those issues especially are the way regulatory and market structures have evolved for traditional public stock markets, and ensuring public markets can provide capital raising opportunities for issuers whose nature or limited ownership spread means that use of those traditional public regulated markets for raising equity capital is unattractive for them.

<sup>2</sup> See ["The IPO Crisis and What We're Doing to Fix It"](#): David Weild; ISEEE 2012

## Issues Slowing SME Capital-Raising In The Equities Marketplace: A Summary

From our understanding of the way in which market regulation is following conventional trends internationally, and market structures are developing in response, the key characteristics associated with markets showing reduced SME capital-raising in the equities marketplace are:

- persistent traditional, but illogical, economic distortions;
  - unjustified different rules for subscriptions to new issues and trading of previously allotted securities;
  - unjustified tax advantages for use of debt over equity and its contribution to over-leverage<sup>3</sup>;
- high compliance costs for small issuers (relative to general corporate compliance and for other forms of financing);
- high costs of capital-raising relative to the amount raised;
- lack of profitability for intermediaries to be involved;
- the switch of intermediary activity (driven by profitability) from capital raising to trading (high cap, high liquidity and turnover stocks of companies which are already successful), and from brokerage to asset management;
- exchanges contributing to and not balancing the switch, by catering to high end markets only (driven by seeking profits as “for profit” businesses);
- a move of trading interest to derivatives, risk and complexity seeking higher margins and profitability; and
- higher capital requirements (to cover risk), driving creation of bigger firms seeking higher risk (e.g., in derivatives).

## Framework For Solution

To encourage renewed interest in providing equity finance for small and medium size businesses a different regulatory environment is required from that which prevails for large public companies and markets. The quickest solution is to provide a “carve-out” from existing regulations.

Firstly, any “carve-out” from existing securities and relevant financial sector legislation and regulation must assume and continue reliance on the existing basic legal framework, i.e., essential structure and governance requirements for different legal entities already provided for established companies; trust and custody law, as appropriate to the jurisdiction (e.g., directors duties and liabilities and trustee responsibilities);, and, basic civil and criminal legal codes already in place (e.g., those for property rights, contract and insolvency law, and to deal with fraud, theft and misrepresentation).

Secondly, to maximise the availability of equity capital for small businesses, governments and regulators need to create the right incentives (and the structures that provide them) for the intermediaries and exchanges that operate the markets to achieve the lowest cost and most flexibility for issuers, as well as unrestricted access to investors and their capital. Likewise,

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<sup>3</sup> See IMF Staff Discussion note “Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions”; Ruud A. de Mooij; May 3, 2011; SDN/11/11

incentives must be provided for the owners of, and investors in, the exchanges to be committed to their purpose and success, not just consider them as one of many means they control to achieve their own successes.

Thirdly, wherever it operates, any market for small business and illiquid securities will need to integrate with the environment of existing markets and structures and legislation for large businesses and liquid securities.

### **Principles For A “Carve-Out”**

Experience over hundreds of years of securities markets shows the basic problems of human behaviour to be addressed in any “fair, open and efficient” market system are:

- disclosure by issuers;
- self-dealing by directors and insiders;
- abuse of minorities; and
- manipulation and other misconduct by investors and intermediaries.

Therefore, any acceptable carve-out framework should not be without reasonable restrictions and must have a minimum set of rules for the conduct of players. Transparent and uniform distribution of information is important to encourage participation, as is the concept of equal opportunity. Sensible standards also reduce information costs for information providers and users. Because one of the fundamental concepts of the provision of secondary markets was to create opportunities for securities holders to sell their holdings (and thus lower the cost of capital-raising for issuers), the carve-out framework needs to cover all participants-- issuers and owners as sellers of securities; intermediaries; and owners and investors. ISEEE members believe the appropriate framework should be based around the concept of a formal public market where the securities may be (and must be, if they wish to gain the carve-out exemption) traded and where the participants agree on simple and fair standard terms of business.

Accordingly we propose four basic principles to be followed to guide the framework for a general “carve-out” from traditional regulatory frameworks to support equity-raising by SMEs. These are:

1. intermediary profitability;
2. low costs to issuers;
3. relevant governance (tailored rules including appropriate oversight and enforcement):
  - commitment to transparency;
  - fairness must be visible;
  - acceptance of responsibility;
  - reliance on reputation in accountability;
4. management of conflicts and risks (rather than prevention or elimination); and



5. simple clear rules, processes and actions and best use of facilitating technology for efficiency, simplicity, ease of access and understanding.

Application of the “principles” and the extent to which any carve-out is needed to follow them, will vary by jurisdiction.

To restore interest in SMEs and their IPOs, the carve-outs need to restore profitability and personal engagement for brokers who support small new issues, lower costs for small issuers to raise small amounts of equity finance, and restore credible and common sense fairness for participating investors. The markets which support these small issuers will not expect to be very liquid and this will be reflected in different (non-traditional) exchange fee and business models. Markets should expect and accept higher volatility without restriction. However, the models must provide for misconduct and manipulation to be punished.

### **Market Ownership Issues And Their Relevance**

Although different markets with different rules may be needed to provide flexibility for issuers, particularly regarding disclosures, intervention seems appropriate to provide some restriction on the number of markets providing public access. Competition among for-profit markets would inevitably reduce the advantages of having standard rules for information providers and seekers, and the pursuit of profits would drive the aggregation of markets into traditional large markets and away from serving small business needs.

However, direct restriction (by regulator or government decision) on the number of for-profit markets allowed is likely to be contentious and inflexible. For that reason ISEEE prefers to incentivise participants to make the markets work best for their intended purpose. One way, for example, would be to require markets qualifying for the “carve-out” to be structured either as partnerships or have spread industry membership ownership, with no ability for owners or controllers to realise the value inherent in that market through demutualisation or sale of the exchange or market facility-- i.e, they have to derive their benefit (and reason for investing) from continued ownership and involvement.

Experience with the development of for-profit exchanges (and for professional firms anywhere where reputation adds value) has shown clearly that having unrealisable value tied up in the business gives owners, partners or members a personal reputational stake in the business. That forces their commitment to protect its efficiency, integrity and success and moderates the inclination to put that value at risk, either through risky investment or by improving profitability of the entity at the expense of customers. In market structures where owners are also the major customers of the market, they are incentivised to keep it efficient and effective for its basic purpose.

## Public Or Private Markets?

A constant challenge for regulation is the specification of boundaries. It is generally accepted that private securities transactions and private markets do not need to be subject to public regulation, and transactions are basically governed by contract law. The model ISEEE is proposing basically extends that freedom into the public arena by carving out these public markets from existing regulation, but on terms requiring them to have their own rules. Current regulation is driving more issuers and investors to private markets for securities. But these restrict access from all potential interested public investors, thus raising the cost of equity finance to private issuers or denying equity finance to them. The starting point for the definition of a public issuer and for public markets which are regulated is generally based on the value (size) of an issue and the number of holders or persons to which an offer is made. . This is necessarily an arbitrary threshold.

The carve-out and market structure model proposed in this paper for public small business markets does not depend on redefinition of the private/public boundary for existing securities market regulation. But, a regulatory change to broaden the definition of public securities would encourage the development of small business markets, i.e., to restrict the definition of private securities (and the rights to them through nominees) to those which may be sold or transferred only to the persons to whom they were originally issued.

The recommendation for this extension of the definition of public securities is based on the principles of uniform distribution of information and equality of opportunity. All potential buyers should be entitled to whatever information is available about securities if they may be bought by anyone other than those to whom the securities were originally sold .

If the attributes of the securities issued allow them to be bought by anyone else, the issue should be regarded as a public issue. Any market facilitating transactions in those securities (or interests in them) is then a public market.

For the purposes of national market analysis and surveillance and review for further regulatory development it is also recommended all public issues be registered, and transactions in those securities be reported publicly and be available to the national oversight body.

This would create clear tiers of regulation of securities and their trading:

- private securities -- those which may only be on-sold to persons who already hold them; and
- three tiers of public securities:
  - those which may be sold to persons who do not currently hold them and are not quoted in SBMs;
  - those which are quoted in SBMs subject to the regulatory carve-out; and
  - those which are quoted in large traditional public markets.

## Proposed General Framework

A framework built around each, or any, public SBM with a carve-out from current regulation to support small business capital formation, and which we consider would conform to the four principles cited earlier, is suggested. In principle the framework could apply without any government regulation of issuers, markets or intermediaries. But, each jurisdiction might choose to integrate it with existing provisions that provide for licensing or registration of market participants, as long as this does not restrict the framework for market operation.

The proposed framework provides a complete and general structure which ISEEE members agree may require tailoring in any particular jurisdiction to ensure it achieves its intended purpose of supporting and encouraging public equity capital- raising by SMEs. However it will not be sufficient to “cherry pick” single ideas from the list of requirements for the framework. As we have seen from its evolution to date, the framework of regulation and market structure is a complex and integrated mix of standard rules and participant responses, and all parts of the framework are interdependent. Small improvements to current frameworks may achieve small benefits, but only a complete approach to a “carve-out” framework, such as that which we propose, will be effective.

➤ ***For Issuers and Sellers:***

- all bids and offers are public, and no restrictions are allowed on persons to whom offers may be made;
- issuers who may list to have their securities quoted is restricted to those making an IPO under a specified size, (or a listing for quotation of existing equities with a market capitalisation under that specified size), or with a small spread of security-holders, or with minimal turnover activity<sup>4</sup>;
- buybacks and sales of additional stock into the market are permitted (subject to any shareholder approval required) provided the market has notice rules for these shares;
- minimal standard disclosure requirements for issuers are established in market rules<sup>5</sup>;
- issuers who have not had a profit for the previous two years are required to have an “Introductory Risk Statement” in the first page of any promoting document for potential investors<sup>6</sup>;

<sup>4</sup> Recommended thresholds are:

- \$100 Million or less; or
- less than 2,000 shareholders (each holding less than 1% of the value of the securities), cumulatively holding less than 25% of the value of the securities; or
- no more than 50 transactions a month in the securities.

<sup>5</sup> Recommended minimums (markets may set their own rules regarding disclosures) are:

- audited financial statements complying with national accounting standards for small businesses filed with the national regulator and distributed to, or readily accessible by, prospective investors;
- investor-friendly offering statements submitted and available electronically; and
- periodic disclosures as for any registered company (annual report and audited annual accounts as a minimum).

<sup>6</sup> This statement would be approved by the market and state briefly and clearly the risks in investing in the issue, e.g., a statement that “A potential investor should be aware that the Company has not made a profit in the past two years and there is no assurance it will be profitable for the next two years”, if this is the case.

- the exercise price of any stock options issued to officers and promoters in the previous year may not be less than the current offering price;
- details of holders who benefit indirectly from the offer and the amounts involved are to be prominently disclosed<sup>7</sup>;
- issuers making an IPO are required to have a licensed broker as sponsor for the issuer (and as a market maker for the issue<sup>8</sup>);
- start up companies have a two year “hold” period for founders/principals securities; and
- if possible in the jurisdiction, as an added incentive, companies in this market should be permitted to have dividends as a tax deduction (as well as interest on debt) for as long as they are listed only in this market.
- **For Intermediaries:**
  - require that intermediaries accessing the market for their clients be licensed (if the jurisdiction has licensing)<sup>9</sup>;
  - direct investor access is allowed on a “hard locate” and prepayment basis (no defaults permitted); and
  - allow intermediaries to make markets, take principal positions and recommend stocks, requiring all conflicts to be disclosed and managed, but not avoided.
- **For securities market conduct:**
  - all markets to have public published rules for participants;
  - require all participants to agree the terms of the “carve-out” before use;
  - place no restrictions on investors;
  - permit trading by directors and officers, - subject to “Notice and Pause” provisions<sup>10</sup>;
  - prohibit naked short sales;
  - all sales or transfers of ownership of quoted securities to be reported, including beneficial ownership transfers, and public identification of parties to the transfer will be a matter for exchange rules;
  - no restrictions on who may place bids and offers on any security listed (including on issue);
  - all disclosures made public (no restricted disclosure to professional or qualified investors);
  - allow appointed market-makers to get deal priority at their quotes;
  - require markets trading these issuers to provide full immediate post transaction transparency; and
  - encourage implementation of prompt and direct settlement to minimise risk and cost<sup>11</sup>.
- **General:**
  - markets (exchanges) to be public (not restricted to use by any particular class of investors);

<sup>7</sup> The statement should detail any issues of stock made in the past two years at prices below the current offering price, who the holders are, and the benefit represented by the current offering price.

<sup>8</sup> For at least for 2 years after the issue. It may not be practical to require market makers for all stocks all the time.

<sup>9</sup> In the U.S. this would be FINRA-registered firms, and equivalent in other countries.

<sup>10</sup> Simple provisions requiring key insiders (directors and management) to give prior notice of intention to buy or sell (including related derivatives if any) during a two week window to receive immunity from insider trading prosecution.

<sup>11</sup> E.g., “Simultaneous Final Irrevocable Delivery Versus Payment” (SFIDVP), T+0, and direct trading to depository/registry coupling all minimise intermediation costs. Standards like XBRL lower information costs.

- governance structures must ensure the exchange acts in the interest of market participants<sup>12</sup>;
- ban individuals or institutions with a previous disciplinary or criminal history from participation (either as owners or in the market); and
- require participants (issuers and intermediaries) to agree that their conduct is subject to supervision and that compliance and fair conduct is enforced by a completely independent professional body<sup>13</sup> (appointed and accepted by participants) with full authority to ban any directors, intermediaries or investors from participation, and to order compensation, restitution, and penalties for misconduct in any circumstance. Rights of recourse to legal action against decisions of the supervisory body are waived (except for breaches of natural justice and decisions made in bad faith). Costs of enforcement or need for recourse to decision by this supervisory body are to be met by affected parties.

A key legislative carve-out requirement would be that it is complete and effective: i.e., to dis-apply any legislation contradicting the requirements for the application of the carve-out and any legislation which would allow review, appeal or overturning of a decision of the supervisory body, or any action which might be taken against a member of that body other than for bad faith.

ISEEE

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<sup>12</sup> e.g.,

- constitutions should specify the purpose of serving market participants;
- ownership or membership interests may not be transferred until held for at least 5 years;
- no distribution of exchange value through capital distribution or repurchase allowed;
- permitted structures include companies, partnerships or memberships;
- annual dividends not to exceed annual profits after tax;
- voting control of at least 51% to be held by issuers and intermediaries;
- no single owner, member or partner to have more than a 20% interest; and
- no long-term debt liabilities permitted.

<sup>13</sup> In the U.S. this might be an executive arm of SEC, but would need to be completely independent. This body should be comprised of industry independent senior professionals only (including non-U.S. members). This is consistent with concerns expressed about the governance of regulators (“Guardians of Finance: Making Regulators work for us”; Barth, Caprio and Levine; 2012; MIT Press; available from Amazon.)