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# Market Structure Redux:

Can the Capital Markets Be Re-Formed on a Broken Foundation? The U.S. loses global ground as it falls further behind other developed nations that create a fertile environment for public companies to grow.

**By Natasha Gural, Editor-in-Chief**

The proliferation of high-frequency electronic trading and well-intended regulatory changes have led to a flurry of unintended consequences that have fundamentally changed, and arguably crippled the market structure, hindering capital formation. Venture capitalists and private equity firms have been pummeled as dealmaking dried up in a marketplace where a lack of Wall Street research combines with the impact of these regulatory changes and a speed-driven electronic trading arms race to prohibit small and mid-cap companies from going public. The uber-efficient markets in the U.S. have subverted the model of long-term investing, creating a need to feed the speed with technology and services, while providing no protection for those with an outlook for growth.

"I think that there are several regulatory changes that have taken place since the mid 1990s that have all conspired to create perfect storm that is leading us to where we are." – **Paul Deninger, vice chairman of Jefferies & Company**

Those seeking to repair the broken market structure point to a host of actions that have forever transformed the landscape, including: decimalization, which slashed trading revenue for investment banks; deregulation of commission rates; the investment banking consent decree, which pays research analysts with trading revenue; the elimination of banking syndication, which allows bookrunners alone to decide where all shares are placed; a lack of Wall Street research for small and mid cap companies; Reg NMS; and the unintended consequences of Glass-Steagall, including the consolidation of boutique banks, which has left underwriters no choice but to focus only on very large clients.

"I think that there are several regulatory changes that have taken place since the mid 1990s that have all conspired to create perfect storm that is leading us to where we are," Paul Deninger, vice chairman of Jefferies & Company, tells Markets Media.

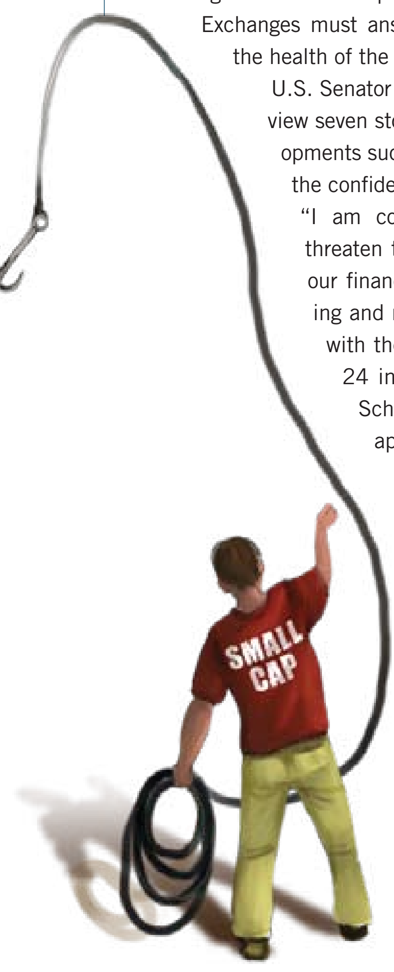
A growing chorus is clamoring for change, with some suggesting the creation of a secondary market to support smaller companies.

"It would be particularly important to repair (the market structure) in these times of economic stress, and the way to repair the market for smaller cap stocks and IPOs is to create a parallel market that would co-exist with the current public market," Michael Halloran, a partner with Kilpatrick Stockton and a former counselor to the chairman and deputy chief of staff at the Securities and Exchange Commission, tells Markets Media.

David Weild, founder of Capital Markets Advisory Partners, senior advisor at Grant Thornton and former vice chairman of the Nasdaq, has long been aware of the mounting problems and advocates the creation of a parallel public market (and improvements to the private market) to support small capitalization companies and with them, IPOs and other financings that will drive economic growth and job formation.

"The last time I looked it was investors who support economic growth, not high-frequency traders. At the end of the day Congress, the SEC and the exchanges must fix our market structure for the sake of the U.S. economy. The silence is deafening. When are we going to wake up to the reality that the IPO market has been crippled by changes in market structure? The problem might have lost its best natural watchdogs, the stock exchanges, when privatization of the exchanges took them from member-owned organizations to public companies that need to grow earnings," Weild tells Markets Media.

Weild adds: "The exchanges now focus on increasing trading volume, capturing trading volume and making geographic and product acquisitions. The core small company listings business has taken a back seat. At the same time, with the repeal of Glass-Steagall back in 1999, the investment banks have consolidated and become so big that the important ones can't afford to care about small companies anymore. The bigger the exchanges become, the more they need scale to grow earnings by competing for trading market share and creating instruments that will trade in large volumes (for example, ETFs, derivatives, etc.) rather than focusing on smaller companies that will help grow the economy. Exchanges must answer to their shareholders rather than the health of the larger ecosystem."




U.S. Senator Ted Kaufman has urged the SEC to review seven stock market practices, saying the developments such as high-frequency trading may erode the confidence of investors.

"I am concerned that questionable practices threaten to further erode investor confidence in our financial markets and that our understanding and regulatory capacity have not kept pace with those changes," Kaufman wrote on Aug. 24 in a proposal to SEC Chairwoman Mary Schapiro. "The current market structure appears to be the natural consequence of regulatory structures designed to increase efficiency and thereby provide the greatest benefits to the highest volume traders."

Kaufman says he's concerned that the SEC rules favor high speed liquidity over execution fairness, noting that on Aug. 21, just four of the more than 5,000 stocks in the U.S. equity market; Citigroup, Bank of America, Fannie Mae and Freddie Mac contributed 20 percent of the volume. He says rules meant to strengthen public order display instead have led to the proliferation of dark pools. Rules have spurred competition with the exchanges, leading to 50 or more execution venues.

"This has led to increased competition for market share, however, that now includes questionable practices such as liquidity rebates, flash order offerings, co-location of servers and other inducement arrangements with broker-dealers and other market participants," Kaufman wrote.

## Market Structure's Broader Impact

In an upcoming whitepaper with the working title "A wake-up call for America: Evidence of the systemic failure of the United States stock markets" co-authors Weild and Edward H. Kim, also a senior advisor to Grant Thornton, argue that while market structure in the United States may be working for large capitalization companies, it is systematically degrading the value of small capitalization companies.

"Market structure has a very significant impact on capital formation, because from the venture capital standpoint we have to answer two basic questions: what are the metrics that are required in order to achieve a public market exit and are those metrics feasible? Eleven years ago it would take six and half years on average for a company to be IPO worthy," Pascal Levensohn, founder and managing partner of Levensohn Venture Partners, tells Markets Media. "Now we're north of 10 years. The problem with that is the market structure has shifted so that the median time to a public market exit now exceeds the life of the VC partnership making the investment. It's a systemic dysfunction."

San Francisco-based LVP manages more than $200 million in committed capital and currently has two active venture capital funds focused on information technology companies, emphasizing digital media, security and demand-side cleantech. As venture capitalists like Levensohn look toward cleantech as the new boon, the systemic problems are clogging pipelines and effectively blocking the dealmaking process.

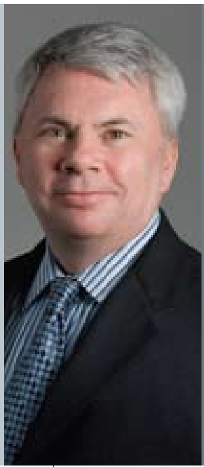
"Either partnership lives have to change, or capital markets have to change," says Levensohn. "The question is: Is it reasonable for it to take 10 years for a venture-backed company to go public? I say no," says Levensohn. "Goldman or another large investment bank would say capital markets are healthy as long as you raise $150 million in IPO money at a market valuation in the range of $500 million. That effectively excludes 90 percent of all venture companies."

Lawrence Leibowitz, group executive vice president and head of U.S. markets and global technology at NYSE Euronext, tells Markets Media: "I think there a lot of things that can be fixed about the current market structure, but I don't think it has any impact on the broader economy."

"I don't think the market structure currently has any bearing on the IPO market. The reason the IPO market has problems is because the economy hasn't been good," says Leibowitz. "If the economy improves, which it already has, we will see the IPO market improve. It has nothing to do with the trading structure as far as I can see."

But Levensohn, Weild and Mark G. Heesen, president of the National Venture Capital Association, say the de-listing of public companies and the collapse of IPOs create a major impact on the broader economy through the loss of jobs, both on Wall Street and Main Street.

# Market Structure Redux | continued



**"It's just the tip of the iceberg as these companies go public and keep growing. These companies are often acquired for one technology, but their entrepreneurial spirit gets stripped out and that will ultimately impact our national and international economy."**

– Mark G. Heesen, president of the National Venture Capital Association

"Statistics show that 90 percent job creation of venture backed companies occurs post IPOs. (Job creation) will not occur if we don't get IPOs back, period, full stop," says Levensohn.

Heesen cites an NVCA study which found that 92 percent of job growth in companies occurs after they go public.

"It's just the tip of the iceberg as these companies go public and keep growing. These companies are often acquired for one technology, but their entrepreneurial spirit gets stripped out and that will ultimately impact our national and international economy," Heesen tells Markets Media. "It takes 10 years to go public. You have to have the patience to wait that long. In this environment investors say they want to see a check. We really have to look at the idea of shepherding these small companies that [have the potential to] become major companies down the IPO route."

## Contagion Spreads

Venture capital investment plunged 51 percent in the second quarter as the lingering recession and the IPO dearth drove down funding for startups to a 15-year low. VC firms invested $3.67 billion in 612 financing deals during the quarter, down from $7.56 billion a year earlier, according to PricewaterhouseCoopers and the NVCA. Just 141 startups had a first round of venture funding, the lowest number since 1994. Industry tracker Dow Jones VentureSource said venture capitalists invested $5.27 billion in 595 deals in the second quarter, a 32 percent jump over the first quarter of 2009, but still lower than the $8.33 billion put into 726 deals during the second quarter of last year.

Startups are expected to raise some $15 billion in capital this year, according to the PwC/NVCA report, compared with $30.6 billion in 2007, the NVCA said. Heesen says just six U.S. startups have gone public this year, and just 10 U.S. companies have pre-IPO paperwork on file with regulators.

"We've already seen a dramatic drop in venture capital formation. The amount of money raised and put into funds this year is a third of last year and going down like a rock," says Halloran, who also previously served as served as group executive vice president and general counsel for Bank of America. "It makes the bigger companies realize they do not have to pay as much to acquire a smaller company because the big companies are the only avenue for liquidity. When venture capital returns decline, venture capital needs to ask for a bigger chunk of companies. So it's like a waterfall effect in the sense that venture capital funds are raising less money, fewer companies are getting invested in, and when they are getting invested in, they have to give up more equity."

Halloran says "fewer sales of companies translates into fewer sales to markets which ultimately leads to smaller markets, which ultimately leads to a real economic problem. It's going to be a national issue; ultimately we will realize that we are slowly but surely eating our tail in the name of cheap commissions and restrictions on research analysts. The lion's share of the jobs in this country are, believe it or not, in the smaller companies, and it's already having an impact on the job market and that will continue."

The Obama administration believes that economic recovery will be driven in large part by America's small businesses, which have generated about 70 percent of net new jobs annually over the past decade, according to the Treasury.

In the private sector, more than half of all Americans are employed by small companies, with less than 500 employees, according to the Small Business Association. According to the ADP National Employment Report, nonfarm private employment at large businesses, defined as those with 500 or more workers, declined by 74,000, while employment at medium-size businesses with between 50 and 499 workers declined 159,000 in July from a year ago. Employment among small-size businesses, defined as those with fewer than 50 workers, declined 138,000. Since reaching peak employment in January 2008, small-size businesses have shed nearly 2.4 million jobs.

As the clamor for consolidation continues, firms that are delisted are not being replaced by new ones, leading to the "incredible shrinking market," as Weild, Halloran and others call it.

**"In the long-term it will (destroy Wall Street) in the sense that the number of public company listings has declined dramatically since 1990," says Halloran.**

The number of companies listed on the NYSE, Nasdaq and AMEX tumbled 22 percent from 1991 to 2008 year end, and tanked 44 percent from peak to trough in listing from 1997 to 2008, according to Halloran.

"And it will go still lower in 2009. Ultimately you have a tighter and tighter market [due to consolidation] that is dominated by larger and larger companies," says Halloran. "Now companies [that are merged with others] are not replaced with new listings. Over time it will destroy Wall Street in the sense there will not be sufficient liquidity in the market other than a group of very large companies. Any IPO of less than a $250 million market capitalization company (and the number is probably higher) is a problem in terms of having enough commission volume to support research and the other activities to take a company public. Actually you probably shouldn't go public without a market cap of less than $750 million. You won't have an aftermarket to support your stock if you do."

According to VentureSource, median deal size continues to shrink, falling to $5 million in the second quarter from $8 million in the second quarter of 2008, and to its lowest level since 1999. "As venture investors are forced to hold on to companies for longer periods of time, corporations are beginning to step in to help carry these companies down the last stretch to exits," Jessica Canning, director of global research for Dow Jones VentureSource, said in a statement.

"The broader impact would be that the companies will have to wait a lot longer to grow bigger to access the capital markets, and that means there will be less capital infusion into these smaller companies," says Heesen. "It's a self-feeding circle. If this continues for another three, four or five years, the overall capital markets and the economy will go into a further decline. The flipside is that if we get it fixed, the equity capital markets can begin again to make a real contribution to economic growth. Everything is supply and demand. If the lack of supply continues, the pipeline will shut and capital markets and those that support them will shut with them. Everyone will live to regret that the supply part of the equation, IPO supply, has virtually disappeared. Like with any other system, if you don't have input, you don't have output."

Venture capital investments in the international markets fell to the lowest level since 2003, with $1.46 billion invested in 250 deals for emerging companies in Europe, Canada, Israel, China and India in the second quarter, tumbling 63 percent from $3.95 billion invested in 452 deals during the second quarter last year, according to VentureSource.

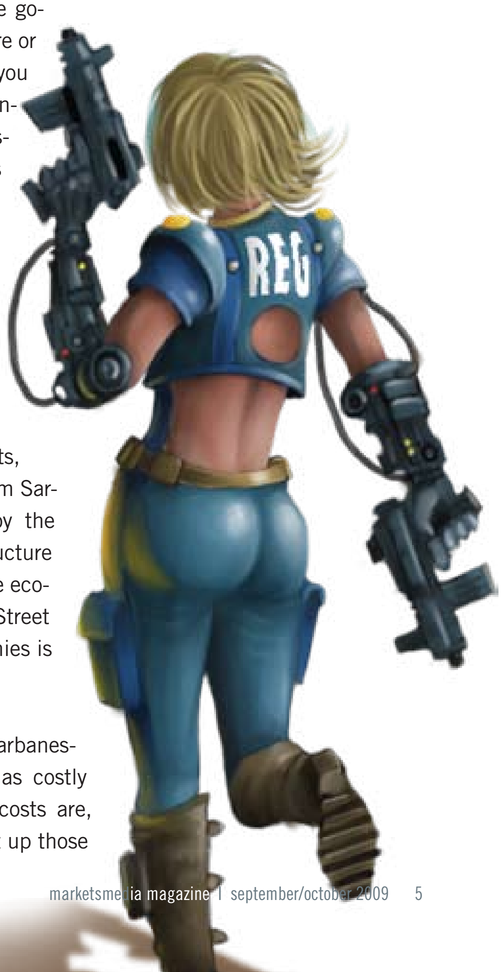
"It would be a mistake for us to continue to assess the relative health of the U.S. IPO market in a vacuum; we need to consider the global markets and consider America's slipping global competitiveness. A deep hole of liquidity for emerging companies in the U.S. is only going to contribute to America's deteriorating position," says Levensohn. "The problem that a lot of people have is they are considering the implications in a very narrow way, and they are not considering the impact of one issue on another. The urgency of resolving this cannot be overstated."

## Beyond Sarbox: The Real Regulatory Ruffles

Pundits have been quick to blame Sarbanes-Oxley for the flight of IPOs from the U.S. to overseas, even as China and other developing countries clamor to support local capital markets.

"A number of things have to be looked at. The SEC is going back and looking at Sarbanes-Oxley and the regulatory environment we're in right now. A response on the SEC's part is to ask if one size fits all. Should regulations to cure ills for Fortune 500 companies be subject to small companies? We need to review the regulations of the last 15 years, looking at things like the Spitzer settlement and decimalization," says Heesen. "While large investment banks help the investor process, we should also look at fostering a new group of young investment banks on how to understand our technology. [We must look at] the idea of garnering large institutional investors [middle tier], the importance of holding assets over the long-term instead of changing daily and getting people interested in your company years before they go public. In terms of tax policy, it appears taxes will be going up in the next couple of years, and we need to make sure to reward long-term investment. That will go a long way to helping this situation. The venture industry is putting investors in front of companies that they are interested in."

Halloran acknowledges that Sarbox is "very costly" in terms of improving internal control over financial reporting, especially for smaller companies. "However," he says, "it is not what has killed the IPO market in the United States. Sarbanes-Oxley didn't come into being until 2002 and there is plenty of evidence that the IPO market was in trouble going back to 1997. I've more or less come to believe that you can amend the internal controls rules under Sarbanes-Oxley, but the accountants are going to spend a lot of money imposing their view of adequate internal controls – to protect themselves from liability. It's a private industry matter."




"Sarbox is partly responsible in that it raises costs, but higher issuer costs from Sarbanes-Oxley didn't destroy the IPO market. Market structure changes that destroyed the economic viability of Wall Street to support smaller companies is what has destroyed the IPO market."

"It's easy to blame Sarbanes-Oxley. As ridiculous and as costly as some Sarbanes-Oxley costs are, (investors) are going to eat up those

# Market Structure Redux I continued

costs and do what it takes to make that company go public. It's an issue, but not the final answer. We believe some of the factors that we have to look at ourselves include: 'Are we putting out companies that investors, professional and every day, believe are companies they have faith in and will do well over the years?' Until we see a steady stable marketplace, it's going to be hard to see cutting edge companies get out there and be accepted by everyday and institutional investors," says Halloran. "Another major reason companies don't go public is that an entrepreneur no longer sees going public as the brass ring. Many say the hassles of going public, like being a babysitter rather than leader, are not worth it. There are constant legal and regulation issues. The problems all add up and it's no longer fun. You're babysitting regulation and litigation."

Former New York Attorney General Eliot Spitzer emerged as the scourge of Wall Street in 2002, when he reached a settlement with 10 major investment banks and brokerages for their roles in inflating stock prices. "This agreement will permanently change the way Wall Street operates," Spitzer said at the time. "Punishment, remedy, and structural change." The probe began with Merrill Lynch and eventually expanded to a dozen banks. He claimed the firms issued bogus positive research reports on stocks and then coaxed their brokers to use the false research to promote those stocks. Spitzer charged that those efforts produced artificial demand for the stocks, pumping up the prices and garnering profits for the firms who were issuing the reports and then selling the stocks.

In April 2003, Citigroup, Credit Suisse First Boston, Bear Stearns, Goldman Sachs, J.P. Morgan Chase, Lehman Brothers, Merrill Lynch, Morgan Stanley, Solomon Brothers and UBS Warburg agreed to pay $1.4 billion. Thomas Weisel Partners and Deustche Bank completed their deals later. The banks contributed $450 million for independent investment research and agreed to distribute reports from independent firms along with their own, but the mandate to make research from other firms available expired for all of the banks except Thomas Weisel and Deutsche Bank on July 26, and will end for them in March.

**"The whole idea of decimalization: Who makes money on this idea? Where is money? [Those] are all problems," says Heesen.**

"Analyst money suffers greatly under the Spitzer settlement. If there is only one analyst following this company, that's as bad as no analyst following your company," he adds. "The Spitzer settlement all comes down to economics. At the end of the day, what is has shown is there is no money in analyst coverage. Most of these are young upstart companies starting up on Nasdaq and they need this kind of coverage."

In addition to the Spitzer settlement, decimalization and the elimination of bank syndication, Deninger points to consolidation of boutique banks as an unintended consequence of the repeal of Glass-Steagall.

"The fall of Glass-Steagall basically re-scrambled the egg that had been unscrambled by the push for antitrust legislation coming from the Great Depression, the House of Lords at that time was felt to be too powerful. Then Glass-Steagall was taken down. That's the first big problem, because what it did was put investment banks in competition with commercial banks, with commercial banks having an advantage. It led to a consolidation of the industry," he says. "It was following the fall of Glass-Steagall that all these boutiques got bought. All these firms got merged and bought and ramped up. Guess what? Big companies need to work for big companies, because they need to move the needle. $300 million in the tech market doesn't move the needle at Goldman Sachs. When these investment banks became very big they had to go after big market opportunities. A tech IPO is not a big opportunity."

## A Second Market

Just 21 operating companies went public in the U.S. in 2008, and just 18 of those were from the U.S., according to IPO expert Jay R. Ritter, the Cordell Professor of Finance at the University of Florida. He notes that a higher volume figure has been reported in many sources (50 counting all firm commitment offerings), but those typically include banks and savings and loans (zero offerings, although there was at least one best efforts offering), oil and gas partnerships or unit trusts (five offerings), ADRs (four offerings), REITs (two offerings), special purpose acquisition companies (SPACs, 16 offerings), closed-end funds (three offerings), other unit offerings, and IPOs with an offer price below $5 (one offering), as well as (mainly domestic) operating companies.

Citing the litany of ongoing problems with the existing secondary market in the U.S., Weild, Levensohn and others join Halloran in the call for an alternative or opt-in market.

"And that separate market would in effect say: in this market you could allow research analysts to participate with investment bankers in meetings with management while still maintaining the strict limits on analyst compensation from banking business that was implemented under NASD Rule 2711," which stipulates that investment banking be run separately from research and trading to ensure trust in the public markets, says Halloran.

Levensohn says it's essential "to raise commissions for small cap companies and to establish an economically viable infrastructure for smaller companies to get greater liquidity."

"You can create this by creating an opt-in market," says Levensohn. "We need to provide liquidity for investors. If we do not do this we are not going to get a resumption [of IPOs]. Otherwise an equivalent market will arise offshore and that will be to the dealogic

**US IPO Volume***

| Priced | Value $bn | No. |
|---|---|---|
| 1995 | 31.52 | 545 |
| 1996 | 48.03 | 779 |
| 1997 | 39.84 | 543 |
| 1998 | 38.61 | 341 |
| 1999 | 66.53 | 484 |
| 2000 | 64.74 | 361 |
| 2001 | 38.90 | 88 |
| 2002 | 25.42 | 86 |
| 2003 | 14.53 | 83 |
| 2004 | 44.35 | 237 |
| 2005 | 37.38 | 222 |
| 2006 | 48.05 | 233 |
| 2007 | 56.14 | 254 |
| 2008 | 31.13 | 46 |
| 2009 YTD | 4.12 | 16 |

**US Venture Capital IPO Volume***

| Priced | Value $bn | No. |
|---|---|---|
| 1995 | 4.77 | 106 |
| 1996 | 22.07 | 390 |
| 1997 | 17.08 | 255 |
| 1998 | 15.07 | 155 |
| 1999 | 32.21 | 346 |
| 2000 | 35.37 | 303 |
| 2001 | 3.19 | 35 |
| 2002 | 1.52 | 9 |
| 2003 | 2.83 | 16 |
| 2004 | 4.75 | 42 |
| 2005 | 4.75 | 53 |
| 2006 | 5.58 | 65 |
| 2007 | 6.23 | 48 |
| 2008 | 0.61 | 6 |
| 2009 YTD | 0.91 | 6 |

****Includes Bermuda, Cayman Islands, and Puerto Rico***

**Source: Dealogic**

detriment to the U.S. There is no enthusiasm for going public in a market when you are going public in a ghost town. Market demand usually creates market opportunity, and there is major demand for a viable small cap equity market that has robust liquidity. There will be an evolution of capital markets from where they are today, and I would like to see that happen in U.S. markets."

Halloran adds: "You would create aftermarket incentives for research analysts, salesmen and traders to focus on smaller cap stocks by creating a viable economic model to support these activities through the fixing of commissions and getting back to stocks being traded the way used to be traded with reasonable spreads ... We need a trading spread 10 cents or 20 cents which is still 'decimal' trading but doesn't destroy trading economics by trading in penny increments. You'd do it the old way, call your broker to place a trade and your broker would have research and analysis at hand and an incentive to talk stocks. An alternative market with this structure creates commission and trading revenues that will support salesmen selling smaller cap stocks, analysts researching the stocks, and traders and underwriters supporting the stocks with capital – both on the IPO and in the all important aftermarket."

## Rummaging for Research

Equity research is no longer correlated with share price, says Weild, and Halloran argues that it's been a problem for years and one that can no longer be dismissed.

"I first started to notice (the lack of research) about 1995-96, but it sort of disappeared from my viewpoint in 1998-99, when we had the dot-com bubble. There was so much going on, we forgot about the issue. In about 2002, the issue had continued so much it (could not) be ignored. I would advise against ignoring it any further," Halloran says.

Leibowtiz said third-party firms like Morningstar provide qualitative, model- based research which doesn't take the place of analysts. "Clearly small cap companies are concerned that as Wall Street retools itself they are not getting enough coverage," he says.

"I think traditionally when it comes time for the IPO the bulge bracket guys get favored, and so there is the challenge for boutiques," says Leibowitz. "The challenge is really to scale that business without it costing too much. The minute you start hiring analysts to do quantitative research, your costs go through the roof. There is a difference between researching 3,000 companies and 300. Certainly companies don't think covering research for mid-cap is worth it because they don't get enough trading volume for it, they don't get activity, enough interest."

Jefferies provides research on companies with market cap below $2 billion "as a matter of strategy," and is the only major firm still covering 100 percent of recent lead managed IPOs. "The unintended consequences of Glass-Steagall coupled with the Spitzer settlement means I can't get paid by taking a company public, I can only be paid by volume of trading. The other unintended consequence is it creates volatility in the market. I'm not saying analysts do it on purpose. If I say buy and hold for 10 years, I never get paid as an analyst. My research now is to encourage trading. It is a perverse incentive in the system that must have some effect," Deninger says.

Halloran says increased market volatility hinders the equity public offering market. "When an underwriter buys the shares and has to resell, if the underwriter has to wind up keeping the shares on his books because the market drops that's not good," he says. "That increased volatility has really hurt the equity public offering market. Volatility erodes investor confidence. At least for the smaller company market, where the volatility is the greatest, my recommendation above is designed in part to address that. My belief is that a market with adequate research and sales support will create aftermarket [after IPO] liquidity in the market for the smaller cap companies that will reduce volatility. It usually has."

**"Wall Street sellside research today is a shadow of what it once was," says Levensohn.**

# Market Structure Redux | continued

Levensohn adds: "This should not be a surprise given the carnage on Wall Street and is not a mystery given that the investment banking consent decree requires sell-side research to be paid out of dwindling commissions. I believe that the boutique investment banks can play a very important role but to point to an increased role by the boutique investment banks as a solution to the emerging growth company capital markets liquidity problem is insufficient. That's very simple."

The big banks continue to vie for the lion's share of the IPO market, and boutiques are battling for talent and marketshare. In August, Lazard, the investment bank led by Bruce Wasserstein, hired Goldman Sachs' Thomas Tuft to advise companies on IPOs.

"We need to reach out to established investment banks and boutiques, at least for joint bookrunning. When you had the Four Horsemen (of Technology) who brought many tech companies to our market, those folks understood how tech companies are different from other established companies. I think part of it is our responsibility," says Heesen. "We, as venture capitalists, need to support both the same investment banks we've been supporting and also introduce ourselves to new investment banks; at least give them something, maybe not the whole package. This is not other people's fault. We have to encourage new boutiques not just by words but by actions."

## Faster and Faster

The proliferation of high-frequency automated trading continues to explode. According to TABB Group, high-frequency trading now accounts for 61 percent of daily equity volume in the United States.

"Whether it's funding businesses, research on Wall Street, trading positions on Wall Street, I am convinced there has been a material loss of quality jobs on Wall Street," says Levensohn. "If you are proliferating an automated trading and market structure that is aligned with hyper spreads, the narrow commission model doesn't pay for quality research, sales overhead, and risk capital commitment. Hyper efficient markets ushered in by regulation have put a lot of people out of work."

High-frequency trading firms generate order flow that is computer-driven and not supported by individuals making fundamental buy and sell decisions, argue Weild and Kim. While proprietary trading firms, statistical arbitrage hedge funds and automated market makers claim to be liquidity providers, some question whether they are really just moving around existing liquidity and creating sophisticated processes to decipher investor order flow so that they can front run, they say.

"This is not a case of high-frequency traders adding liquidity. The high-frequency community is increasingly poaching investor liquidity. The better funded platforms with the biggest computer arsenals hire the best mathematicians and profit by taking advantage of the least sophisticated investors. This has gone way beyond cutting transaction costs to deliver value to investors," says Weild.

Weild adds: "We are now to the point that they are driving volatility, hurting real investors, hurting consumers and destroying the very reason that capital markets exist – to fund businesses, create jobs and drive economic growth. (Can any consumer keep up with a well-funded institution engaged in the computer-arms race of better trading technology?) Just look at the depression in IPOs over the last decade and you can see that this 'faster and cheaper' ideology gripping our stock markets is an absolute disaster for the American economy. We took a culture that was long-term investment focused, and destroyed the whole infrastructure that supported that investment focus (research, capital commitment and sales support), and created a whole new infrastructure that supports trading."

Critics claim high-frequency trading, in which firms trade large amounts in fractions of a second, distorts prices and hurts average investors. But proponents argue the rise of high-frequency trading has boosted liquidity to markets, allowing money managers to be more diversified across asset classes.

"I think high frequency trading in general is good for the market. Given the current structure it's really just the modern day implementation of the market maker in a fully electronic high speed market. So in general I don't think high frequency traders have an advantage over other traders," says Leibowitz. "They are just injecting liquidity in a world where for the most part there are no market makers who have obligations to the market. In the old days, Nasdaq had market makers who had obligations. There are no obligations as a market maker now. In that world you need high-frequency traders. If you didn't have them the market would be very volatile and much less liquid and [would have] wider spreads."

Under Regulation NMS, passed in 2005 by the SEC, transaction costs declined and non-exchange trading firms became more accessible for high frequency hedge funds, prop trading desks and market makers.

"High frequency trading in a decimalized commission environment means you are not going to get sufficient liquidity from equity trading in small cap companies," says Levensohn.

"This is not a case of high-frequency traders adding liquidity. The high-frequency community is increasingly poaching investor liquidity."

– David Weild, founder of Capital Markets Advisory Partners

"This further exacerbates the negative impact of the absence of risk capital for market makers to take overnight positions. Small cap high frequency trading is really bad because you not only get increased volatility, you get a complete mismatch between short-horizon investment capital and the type of long-term investment support that you need to have from your shareholder base. You are institutionalizing dysfunction," Levensohn says.

## The Decimal Difference

In June 2000, then-NYSE CEO Richard A. Grasso told a Congressional committee that decimals would generate stockholder savings. Prior to 2000, stock prices had been measured in sixteenths of a dollar, or 6.25 cents. Then price increases became measured to the penny, making smaller fluctuations in price – and smaller commissions – possible. At the time, Grasso said: "By bringing the U.S. into conformity with international practices, decimalization should improve the competitiveness of the U.S. markets."

NYSE and Nasdaq completed their decimalization on Jan. 29, 2001 and on April 9, 2001 respectively. Since then, the change, which has narrowed spreads, continues to stir debate over its potential harm to investors as volatility thrives. Advocates argue that it reduces the costs of trading by permitting liquidity providers to tighten the bid-ask spread, and that it helps investors by clearly stating the exact price of a stock.

"There has been a move from the SEC pushed forward by large investors to make it as cheap as possible to move stocks. That nearly frictionless trading environment increases volatility because people trade more frequently," Deninger says. "It makes it extremely difficult to trade small cap stocks It used to be in the old days, that $500 million or less stocks you didn't have trade on the decimal so you could actually make money on the spread. The benefit to that system was that is provided revenue for an investment bank that was willing to provide liquidity in smaller cap stocks. The market making function and liquidity around these small cap stocks declined dramatically. It would help the system if there was a reversal of decimalization for low volume shares. It would bring liquidity to the market."

**Leibowitz says changes like Reg NMS and decimalization "were designed to help incent displayed liquidity, and the opposite has happened. Less and less is displayed."**

"Decimalization has had a big impact because first of all it led to less natural liquidity in the market because before liquidity used to be clumped and now a lot of it doesn't want to be seen anymore. So decimalization and Reg NMS combined led to less displayed liquidity," Leibowitz says. " I also think decimalization made it more possible to have high frequency trading."

Former SEC Chairman Arthur Levitt, the architect of decimalization, said it would result in smaller spreads on trades, benefiting investors by making market makers more competitive, and prices would be easier to understand. "The convention of quoting stock prices in fractions dates back more than two hundred years. Currently, the United States securities markets are the only major markets not to price stocks in decimals. As the securities markets become more global, with many stocks traded in multiple jurisdictions, the U.S. securities markets need to adopt the international convention of decimal pricing to remain competitive. And the overall benefits of decimal pricing are likely to be significant. Investors may benefit from lower transaction costs due to narrower spreads," he said in 2001. "Moreover, the markets will be easier to understand for the average investor, who is used to dealing in dollars and cents for every-day transactions. It is time for the U.S. securities markets to make this change."

"I don't think the SEC at this point is focused on this at all. They have many other things to focus on and so I think they need to focus on it and I'm thinking that as people figure this out, they are going to go to the SEC to have them address it," says Halloran. "Under Arthur Levitt, the SEC implemented decimalization which would have been fine if they left it at 20 cent and 10 cent spreads but they drove it all the way to penny-spread trading. Years before that the SEC unfixed [deregulated] commissions … I think the agency won't address [the problem with market structure] unless both the Administration and the Hill give them a pass to do it."

## Banking Changes

The investment banking industry has undergone tremendous change, with the unprecedented events since the collapse of Bear Stearns and Lehman Brothers adding to the seismic shifts in the already fragmented landscape, which have had a profound and damaging impact on dealmaking.

"I think several things have happened since September. No. 1, the most important is the will to change from the VC community and that will come from two things. One, it is now clear in the financial crisis that these large investment banks are not the geniuses everyone thinks they are," says Deninger. "Jefferies didn't take TARP. We were leveraged 6-1. The financial crisis shows these firms were not reliable and focused on their accounts and maybe it is worthless. Some people in the venture industry started to panic. In three of last six quarters, there have been no IPOs. There has never been another period in VC history that happened. That is a watershed event. 'Oh, my God! The IPO market is broken? Everyone has been telling us it's fine."

Deninger points to the fundamental changes in investment banking which favor the big firms, who distribute shares among a small, select group of investors and keep liquidity in the hands of a few rather than rebuilding the marketplace.

"Look at the Cisco IPO or any other in the '90s or late '80s. You see two lead managers and a selling syndicate. Look at a cover today, and what you see is one to two bookrunners and two to five managers. It's radically different. But it's not just the number that's different. The rules are different. In the old days, syndication basically said 'I don't care where I am in the cover, I am going to get shares to sell. I am going to get 100,000 shares and I am going to give that to my five or 10 best institutional or best retail accounts.' You had better and broader distribution of shares to a wider range of investors," says Deninger.

# Market Structure Redux I continued

Morgan Stanley and Goldman Sachs typically get about 80 percent of their commission from 80 to 120 accounts, says Deninger.

"Because they are the biggest commission players, it follows logically that they are the biggest funds. In the old days, Morgan Stanley was one of two leading managers and there was a selling syndicate," he says. "Today bookrunners decide where every single share gets allocated."

The typical middle market firm gets 80 percent of its commission from 400 firms, says Deninger.

"At Jefferies, we are less concentrated from the investors and less indebted to them. We are more likely to allocate shares elsewhere. This elimination of syndication is a huge change. In the old days, Morgan Stanley did 10 (percent) to15 percent of IPOs, Goldman did 10 (percent) to15 percent. Today the VC industry thinks if Morgan and Goldman don't run the IPO they are not worthy," he says.

**Says Deninger: "It's baloney that nobody cares about a $1 billion company. Major companies are below $1 billion. This is a major shift."**

Deninger says the VC community of the '80s and '90s understood the role of small cap IPOs, and understood the role of the middle market growth-oriented investment bank and middle market investor.

Now, he says, "The VC industry has to lose its brand bigotry. There are investors who are interested in $500 million companies, but they do not do business with Goldman. This is one of the holy wars that is going on in trying to resuscitate the small cap. The bulge bracket has decided they want to control this market and the VCs are complicit in this and not taking advice from other investment banks that really have their best interest at heart."

## IPO or Bust

Waiting a decade to go public is daunting and discouraging, and further exacerbates the problem for venture capitalists who already endure a long planning process ahead of dealmaking.

"A venture capitalist needs to exit his or her deal at a specific time. There are three ways to do that: IPO M&A or go out of business. The third one, you don't want to go down that road," says Heesen. "The IPO market has been essentially shut down for a year and eight months. There have been six venture-backed IPOs (so far) this year, and six in total last year. It's not just essentially shut down, it's shut down. What is adding to this, what concerns us going forward is we're not even seeing companies seeking to register for IPOs. There are fewer than 15 registered. Traditionally we saw a healthy situation where 60 percent went the M&A route and 40 percent went IPO. Now 90 percent go the M&A route, and it is a rare bird that goes the IPO route."

As high-frequency automated trading consumes more and more daily equity volume in the U.S., it becomes increasingly tough for small companies to go public.

"What happens in many cases is instead of creating one company that goes public, they create several companies that get acquired. A concern of managers is how quickly stocks move. Ninety percent of stocks change hands every couple of weeks because of hedge funds and other short-term investors, so you don't know what's happening next week or how to plan. It's critically important to have long-term investors. At this point, there are more traders than long-term investors. It makes it difficult for companies to go public, but you still see willing buyers," says Heesen.

The public behemoths will continue to scoop up smaller, nimble firms with innovative offerings, but as the big get bigger, the market gets smaller and smaller.


"You still see the Ciscos, Intels and IBMs out buying companies, and they will continue to do so because that's how you build R&Ds. There continues to be willing buyers out there. Are they buying fewer companies and cheaper ones than before? Of course," says Heesen. "This economic downturn isn't going to last forever, and we will see the quality of acquisitions get better in the next couple quarters. If you continue to see a contraction in the number of companies that can buy companies, there will be an ongoing problem. Another problem is globalization. More foreign companies are buying U.S. companies."

Noting that the NYSE had two IPOs on Aug. 12, the day of his interview with Markets Media, Leibowitz says the IPO market is "certainly is already bouncing back."

The Aug. 12 IPOs were Nashville-based Emdeon, an electronic medical billing provider owned by private-equity firms General Atlantic and Hellman & Friedman, and hotel magnate Barry Sternlicht's Starwood Property Trust, the fifth domestic and the largest REIT IPO to list on the NYSE in 2009.

# Market Structure Redux | continued

For the Emdeon offering, a total of 23.7 million shares, two million more than expected, were sold at $15.50 each, the high end of the expected price range. Underwriters were Morgan Stanley, Goldman Sachs, UBS and Barclays. While the company which processed nearly half of all electronic payment claims in the U.S. last year reported that revenue in the first six months of the year grew 5 percent to $444 million and net income doubled to $17.8 million, some analysts question whether it can sustain that growth. Emdeon was trading at $17.21 on Aug. 27.

Starwood Property Trust's REIT IPO of 40.5 million common shares priced at $20 per share was the largest IPO in 2009, according to Renaissance Capital. Sternlicht's Starwood Capital Group, a private-equity firm specializing in real-estate investments, increased its offering from 25 million shares because of strong demand. Bank of America Merrill Lynch, Deutsche Bank Securities and Citi were the joint book-runners, and Barclays Capital, Wells Fargo Securities, Calyon Securities, Cantor Fitzgerald, Piper Jaffray and Scotia Capital acted as co-managers. Shares were trading at $ 19.82 on Aug. 27. Many real estate investment trusts have been raising funds through secondary stock offerings and then using proceeds to pay down near-term debt, according to the National Association of Real Estate Investment Trusts.


Leibowitz, who denies any impact by current market structure woes on the economy, says: "Almost any backer will tell you if the economy stays here or gets better, companies will start coming to market. We had a year and a half window where everything dried up. Companies were afraid to go to market and investors weren't interested. Now things are starting to heal and get back together and the economy is starting to get significantly better."

Even small cap IPOs will come back, says Leibowitz. "I think ultimately you will see [small cap company IPOs]. What you see now are IPOs of higher quality companies because people don't want to see an IPO flop now. They want to be confident in it, so you are seeing higher quality companies, and that will start to broaden out as people feel more confidence in the market," he says. "They [higher quality companies] have a better track record, a better financial position. That is not a judgment on some of the others. When a banker and owners evaluate 'Would I come public?' they want to be sure it's OK. They want to go find investors who buy the story, and it's the value investors who are really active right now. Value investors want companies with reasonable earnings or certainly long-term prospects."

"VCs and private equity both are still in a world of hurt. It's not easy to get credit. There's all sorts of issues involved there. On the other hand they probably have a bunch of things they own in the pipeline that they'd like to see go public as soon as things get better."

## The Next Frontier

**The constant challenges compel venture capitalists to always be ahead of the curve, building new industries rather than chasing trends.**

"There is a shift from where we have traditionally invested to where we will invest. There is a movement away from IT investing which continues to be very important, but the reality is we are seeing less of that. Money today is going to life science and exciting advances in biotech. In five to 10 years, there is going to be a lot of interest in the clean energy, green tech area," says Heesen. "You could see some very exciting companies come out of clean tech which will excite institutional investors. We see those companies coming out of this clean tech space. There are many clouds on horizon, but is this glimmer of hope. Clean tech has the ability to shake things up. The reason we're seeing a shrinking number of companies on Nasdaq and NYSE is because (foreign) companies are more comfortable to go public on their exchange in their country. As foreign markets mature, you're going to see domestic companies go public on their markets. That's not a bad thing internationally, but a damper on the U.S. market."

There already are signs of growth. Investment in alternative-energy companies rebounded in the second quarter, with venture-capital funding increasing 12 percent from the previous period, according to consultant firm Cleantech Group and Deloitte Touche Tohmatsu. The industry isn't out of the woods yet. The total investment, spread among 94 companies, was still 44 percent lower than the $2.15 billion a year earlier.

The clean technology sector, which includes alternative energy, pollution and recycling, power supplies and conservation, jumped 15 percent to $274 million in the second quarter from the first quarter, according to the MoneyTree Report from PricewaterhouseCoopers and the NVCA, based on data provided by Thomson

Reuters. The number of deals completed in the second quarter remained flat at 42, compared with the first quarter. Despite the rise, investment levels have a long way to rebound from 2007 and 2008.

"There is a crisis of liquidity. Historically, relatively small VC companies reflect and say maybe we do need to invest in an ecosystem maybe it isn't so easy. No. 2, we are now in a slow growth economy, most people don't people think there will be a V-shaped recovery, most people think there will be a premium for growth. That means you will have to buy growth companies again," says Deninger. "There is a two, top three, year cycle where you will see growth companies again. People will look at small cap companies because they need the alpha. For this reason I have hope, I think you are going to see the emergence of new growth industry coming out of the economic slump. With alternative energy, cleantech, I think you are going to see a signs in 2010 and 2011, you will see a significant number of companies go public in the cleantech space. It's going to get people interested. Fourth, Washington is going to have to wake up and see that unintended consequences have to be addressed. When times are good, nobody worries about job creation and growth. Once we're done jamming up the deficits people are going to say we have to grow our way out of this. They have been able to ignore. "

Amid unprecedented government intervention in the financial markets, regulators and legislators are grappling with how to oversee the behemoths and fend off future collapse. At odds with President Obama's plan to focus power on the Fed, Schapiro wants a single systemic-risk regulator to collect information from the biggest financial firms and, where necessary, force them to raise capital and hold more liquid assets through standards "developed by the council." Congress is mulling legislation that would enact Obama's proposal for the biggest revamp of financial markets oversight since the 1930s.

"Certainly this administration has taken this initial action to cast a very wide net, the widest net possible. I think everyone's scratching their head now because players have changed and these things are going to take a lot longer," says Heesen. "It's not like in old USSR where you just got things done. Each country has leaders change, parties change and ideologies change. This democracy thing can be problematic sometimes.

Looking back, Deninger notes: "There are some good reasons why this is happening. Before we talk about how we shot ourselves in the foot, globalization is working. From 1950 to 2000, during that period of time, the U.S. was the envy of the world except for a period of time in the Carter and late Ford administrations when we went through deflation. We were an oil exporting company until 1949. That's followed by our incredible leadership of the global technology industry. U.S companies were fastest to adopt technology in other industries in order to enhance performance."

"Just as we feel it is natural that American companies go public on the NYSE, Indian companies and Chinese companies should want the same, and the Nasdaq. Then naturally we are going lose the virtual monopoly that New York had. In Russia and China, where companies were privatized, in 2007, the two largest IPOs took place in Russia and China," he says. "That the greatest expression of capitalizing – public offerings – took place in communist countries is fascinating. Democratization of capitalism is a good thing, but that doesn't mean we should be shooting ourselves in the foot."

As Congress, the Obama administration and the SEC grapple with the Herculean task of mending the ailing economy, it's unlikely they are even aware of the fundamental market structure changes that result in mounting unemployment.

**Leibowitz believes the current market structure can be "fixed," but that "I think it's going to take some hard actions by the SEC to step in."**

"I think that once [the Obama administration] thinks about this problem, it will see that it is one of the solutions to creating jobs in this country that does not require the government spend a nickel; creating a different market in which these smaller capitalization companies can go public without spending federal money," says Halloran. "This market will form itself once an environment that creates commission dollars and trading revenue is created that will in turn support higher amounts of higher quality research."

It's still unclear what, if any significant, impact TARP, the $700 billion U.S. bailout program for financial firms will have on the markets and the economy, but such programs do not even begin to address the problems with market structure. (For more on TARP, read Online Editor Riley McDermid's story on page 22.) As the U.S. falls further behind other developed nations in terms of publicly listed companies, bigger firms continue to slash jobs and the number of smaller ones, who employ the majority of Americans, continues to shrink.

"We all have to realize that the underlying engine for economic growth is private enterprise. That's how taxes get paid it this country, either by enterprises or their employees. If we continue to stimulate it by government funds, it creates an artificial market," says Halloran.

"We have to find a way to stop that so we can allow the market itself to operate so there is reliable asset pricing and reliable trading," Halloran says. "At some point we need to find ways to stimulate and restructure the market without government money because that's artificial. We need to let the markets find their own way at the end of the day."