HOW ROADBLOCKS IN PUBLIC MARKETS PREVENT JOB CREATION ON MAIN STREET

HEARING

BEFORE THE

SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

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HOW ROADBLOCKS IN PUBLIC MARKETS PREVENT JOB CREATION ON MAIN STREET

TUESDAY, NOVEMBER 15, 2011

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:48 a.m., in room 2203, Rayburn House Office Building, Hon. Patrick T. McHenry (chairman of the subcommittee) presiding.

Present: Representatives McHenry, Guinta, Gowdy, and Quigley.

Staff present: Drew Colliatie, staff assistant; Gwen D'Luzansky, assistant clerk; Linda Good, chief clerk; Peter Haller, senior counsel; Christopher Hixon, deputy chief counsel, oversight; Devon Hill, minority staff assistant; Jennifer Hoffman, minority press secretary; Brian Quinn, minority counsel; and Steven Rangel, minority senior counsel.

Mr. MCHENRY. The committee will come to order. This is the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs. Our hearing is entitled, "How Roadblocks and Public Markets Prevent Job Creation on Main Street."

It is the tradition of this subcommittee to begin with the reading of the Oversight and Government Reform Committee's mission statement.

Oversight Committee Mission Statement: We exist to secure two fundamental principles: First, Americans have a right to know that the money Washington takes from them is well spent; and, second, Americans deserve an efficient, effective government that works for them. Our duty on the Oversight and Government Reform Committee is to protect these rights. Our solemn responsibility is to hold government accountable to taxpayers because taxpayers have a right to know what they get from their government. We will work tirelessly in partnership with citizen watchdogs to deliver the facts to the American people and bring genuine reform to the Federal bureaucracy. This is the mission statement of the Oversight and Government Reform Committee.

With that, I will recognize myself for 5 minutes for an opening statement.

Over 2 years into our economic recovery, America's labor and capital markets continue to face unprecedented challenges. Tens of millions of Americans remain unemployed or underemployed, economic growth is anemic, and small business continues to struggle to access capital, all of which exists despite an endless number of government initiatives.

Recently, our subcommittee examined barriers to small business capital formation, particularly focusing on the pre-IPO market. We heard from market participants and experts who explained the repercussions that outdated SEC regulations have on the formation of startup companies. I am proud to say that earlier this month the House passed with broad bipartisan support—which is often rare in Washington and right now exceedingly rare—we passed several pieces of legislation to roll back these out-of-date and burdensome regulations. Now the next move goes to the U.S. Senate, where we hope that they will take positive action.

Today's subcommittee hearing takes the next step of examining the life of small- or medium-sized businesses, this time in the post-IPO world. While some might associate the IPO market with people becoming overnight billionaires or ringing the bell at the New York Stock Exchange, or the bell at NASDAQ, the reality is that the health of our Nation's IPO market is a signal of its economic growth, innovation, and job creation. Businesses use the capital that they raise through an IPO to grow and expand, which means investing and hiring. In fact, over 90 percent of jobs created by a company are done after it goes public. That is important to note. This is not about the founders putting money in their pockets. It is about giving the company the capital it needs to grow and expand and innovate.

Recognizing today's dismal unemployment rate and job numbers, it is no surprise that America's IPO market is suffering. Experts point to market structure and liquidity issues for small- and medium-sized companies as a primary reason. For one, the rapid increase in high-frequency trading has directed money toward the established liquidity of the higher cap companies. This trend has discouraged the kind of attention startup companies used to garner from investors who used to target them and other small businesses that showed promise of hidden value. Another mentioned item is the abrupt reduction in equity research. Even if investors are intent on finding a diamond in the rough, the lack of information discourages this effort.

These market realities and others are why we have invited two of the world's major stock exchanges, the New York Stock Exchange and NASDAQ, to explain the importance of liquidity for small-cap companies and what can be done to strengthen the U.S. IPO market.

Our focus is not to reverse market expansion or efficiencies. Instead, our aim is to understand why small- to medium-sized companies have second thoughts about going public and the influence that hesitation has on our economy and job creation. With small companies out to fend for themselves in the public market, experts and academics have suggested the formation of agreements between companies and brokers or even exchanges to create a market in the issuer's security. Such agreements would allow small companies the ability to produce an orderly liquid market for their stocks that is observed for many household brands. As the saying goes, liquidity begets liquidity. Research has shown that these agreements, already permitted overseas, have led to a positive influence on liquidity for small public companies.

However, like most new ideas, such a direct agreement requires a change in regulation, this time by both FINRA and the SEC. Today is an opportunity to learn the purpose and effects of these regulations and where there is room for improvement. Orderly markets are one of our Nation's greatest strengths. Providing capital, access to businesses, and choice to investors is obviously at the heart of this. In the midst of our slow recovery, it is imperative that we continue to improve our markets to spur innovation and job creation.

I am interested to hear from both our witnesses and both exchanges today about the challenges our small, public companies face and what can be done to fortify our post-IPO world. I appreciate their attendance and I look forward to their testimony.

With that, I recognize the ranking member, Mr. Quigley of Illinois for 5 minutes.

Mr. QUIGLEY. Thank you, Mr. Chairman.

Today's hearing will examine how roadblocks in public markets prevent job creation on Main Street. It will focus on how newer and smaller publicly traded companies encounter problems accessing capital from U.S. equity markets. The stock of smaller publicly traded companies often suffers lower trading liquidity. This means that small companies often cannot offer enough shares at prices that are acceptable to buyers or that companies cannot sell their shares quickly enough. Small publicly traded companies do not have brand name recognition and often have difficulties attracting investors. Some suggest that the U.S. market structure itself is a roadblock for small companies.

In a statement prepared for a joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues meeting, David Weild, a former vice chairman of NASDAQ, stated, "The stock market structure today is disastrous for the vast majority of small capitalization stocks with asymmetrical order books. Who is there to create liquidity for the small capitalization stocks? The answer is often no one."

I think it is important that our examination seeks to answer why no one is there to create liquidity for small capitalization stock. I also believe we should be innovative in finding ways to create liquidity for small-cap stock in the United States to ensure equity markets are competitive and attractive for both issuers and investors. Improving small publicly traded companies' access to capital will contribute to the growth of these companies and their ability to create jobs.

Any solutions we explore today must also permit our U.S. markets to function effectively and help ensure investor confidence in U.S. markets. However, while I favor bold action in bringing capital to American businesses, we must not sacrifice investor protection. Only a couple years ago in 2008, we witnessed how inadequate financial oversight led to fraud, recklessness, unscrupulous behavior, and manipulation in the market which caused the greatest financial crisis since the Great Depression. That is precisely why Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, to reform the U.S. financial regulatory system and to address the lack of accountability for Wall Street firms that caused the crisis or helped cause the crisis.

Mr. Chairman, I thank you for holding this important hearing and I look forward to the testimony of our two witnesses. I yield back.

Mr. McHenry. I thank the ranking member.

[The prepared statement of Hon. Mike Quigley follows:]

ONE HUNDRED TWELFTH CONGRESS

Congress of the United States

House of Representatives

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Opening Statement
Rep. Mike Quigley, Ranking Member

Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs
Hearing on "How Roadblocks in Public Markets Prevent Job Creation on Main Street"

November 15, 2011

Thank you, Mr. Chairman.

Today's hearing will examine how roadblocks in public markets prevent job creation on Main Street.

It will focus on how newer and small publically-traded companies encounter problems accessing capital from U.S. equity markets.

The stock of small publically traded companies often suffers lower trading liquidity.

This means that small companies often cannot offer enough shares at prices that are acceptable to buyers—or that companies cannot sell their shares quickly enough.

Small publically traded companies do not have brand-name recognition, and often have difficulties attracting investors.

Some suggest that the U.S. market structure itself is a roadblock for small companies.

In a statement prepared for a Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues Meeting, David Weild, former Vice-Chairman of NASDAQ, stated:

> [The] stock market structure today is…disastrous for the vast majority of small capitalization stocks with asymmetrical order books …Who is there to create liquidity for the small capitalization stock? The answer is often "no one."

I think it is important that our examination seeks to answer why "no one" is there to create liquidity for small capitalization stock.

I also believe we should be innovative in finding ways to create liquidity for "small cap" stock in the U.S., to ensure our equity markets are competitive and attractive for both issuers and investors.

Improving small publically traded companies' access to capital will contribute to the growth of these companies and their ability to create jobs.
Any solutions we explore today must also permit our U.S. markets to function effectively, and help ensure investor confidence in U.S. markets.

However, while I favor bold action in bringing capital to American businesses, we must not sacrifice investor protection.

Only couple of years ago, in 2008, we witnessed how inadequate financial oversight led to fraud, recklessness, unscrupulous behavior, and manipulation in the market, which caused the greatest financial crisis since the Great Depression.

That is precisely why Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act last year—

—to reform the U.S. financial regulatory system, and to address the lack of accountability for Wall Street firms that caused the crisis.

Mr. Chairman, I thank you for holding this important hearing, and I look forward to the testimony of our two witnesses.

Contact: Ashley Etienne, Communications Director, (202) 226-5181.

Mr. MCHENRY. The full committee chairman has joined us and has requested 2 minutes, and the chairman is recognized for 2 minutes.

Mr. ISSA. I thank you chairman, and I thank you for holding this important hearing. Your leadership in this area has been essential, whether it is public companies reforming the mistakes made under Dodd-Frank, including the DATA Act and other essential reforms that were never included in that act. As we all know, Bernie Madoff succeeded in the largest Ponzi scheme in American history because of an absence of transparency that could have easily made not just a few smart people who pushed the SEC on behalf of the investors, but the entire public very aware that he was trading in nothing. So I know that the work you are doing there, along with crowd funding, is essential.

I join with Mr. Quigley on the need to have small capital funds not become orphans. But at the same time it is very clear that a great many companies should be allowed to have a broad group of sophisticated investors without the need for full public scrutiny and full public access. Often institutional investors, knowledgeable and with their own resources, given an audited financial statement, will make a wiser, more informed, and larger contribution. So there are many ways in which we can help reform the capital markets.

I share with Mr. Quigley the need to make sure we never again have a meltdown, and that is where the work that you and others on the committee have done to try to get at Fannie and Freddie, very much the causes of moneys not being traceable or accountable had a root in that collapse that we all suffer from to this day.

So, Mr. Chairman, thank you for the continued work. I might note the presence of the House Chaplain who has seen fit to begin looking at the work of our committee, and perhaps that is the best sign of all. I yield back.

Mr. MCHENRY. Thank you, Mr. Chairman.

Father, we ask for your prayers.

Members will have 7 days to submit opening statements for the record. We will now recognize the panel of witnesses.

We have Mr. Eric Noll, who is the executive vice president of NASDAQ OMX Group. We have Mr. Joseph Mecane, executive vice president and co-head of U.S. Listings in Cash Execution and is testifying on behalf of NYSE Euronext.

It is the policy of this committee that all witnesses be sworn in before they testify. If you will please rise and raise your right hands.

[Witnesses sworn.]

Mr. MCHENRY. Let the record reflect the witnesses answered in the affirmative. Thank you. You may be seated.

With that, we will recognize you each for a period of 5 minutes to summarize your opening statements. We have a simple light system. It is a traditional light system. Green means go; yellow means whoa up and sort of wrap it up; and red, go as fast as you can, says Mr. Quigley. So at the yellow light that means you have 30 seconds to wrap it up.

We will now begin with Mr. Noll.

STATEMENTS OF ERIC W. NOLL, EXECUTIVE VICE PRESIDENT OF NTS MANAGEMENT, NASDAQ OMX GROUP, INC.; AND JOSEPH MECANE, EXECUTIVE VICE PRESIDENT AND CHIEF ADMINISTRATIVE OFFICE FOR U.S. MARKETS, ON BEHALF OF NYSE EURONEXT

STATEMENT OF ERIC W. NOLL

Mr. NOLL. Thank you, Chairman McHenry and Ranking Member Quigley. At NASDAQ OMX we believe the challenges that we face in today's equity markets around liquidity and capital formation can be addressed by actions in four areas: one, addressing market structure weaknesses and their concurrent effect on price discovery; two, changing the lack of regulatory focus on rules and trading venues that would assist in the development of vibrant small company growth; three, removing regulatory barriers to small- and mid-cap companies that impede the IPO process and raise the cost of being public for those companies; and, finally, not directly related to liquidity and capital formation, but to assist companies in building their business, the development of an H1B and other immigration reforms to assist those companies in their internal hiring and growth plans. We believe that addressing these issues is critical for generating job creation and growth in the U.S. economy.

Today's U.S. markets, the engine of economic growth, are increasingly fragmented and volatile. Liquidity in U.S. stocks is disbursed across 13 exchanges and over 40 other execution venues. Nearly one-third of public company stocks trade 40 to 50 percent of their volume away from the organized exchanges. In the past 2 years the percentage of U.S. market share traded in those systems that do not post their bids and offers rose from 20 percent to over 30 percent. Many retail and core investor orders are executed away from those primary exchanges.

While we identify market fragmentation as the source of some of the issues in regard to capital formation in the United States, there have been many benefits of that fragmentation. They have reduced investor costs and improved execution qualities in already listed securities. However, the unintended consequences of that market fragmentation have been a lack of liquidity and price discovery in listed securities outside of the top 100 traded names and a disturbing absence of market attention paid to small-growth companies by all market participants, including exchanges.

Although recent market volatility has led to a slight movement toward exchange markets, trading in shares of public companies on these private trading systems accounts for more volume than on NASDAQ and the NYSE combined. Price discovery and available transparent liquidity are essential parts of vibrant market systems.

Just as our markets continue to evolve and adapt, so must the regulatory structure of our markets. We support the development of a consolidated audit trail with real-time market surveillance and new regulatory tools to help regulators keep pace with technology advances and other changes in the markets.

Between 2003 and 2007, the amount of capital raised by private equity funds increased by 300 percent. Issuing private equity allows companies to avoid disclosure and governance obligations created to protect investors. 2008 and 2009 were the worst years for IPOs since at least 1980. In 2009, there were just 12 venture-backed IPO's, raising $1.6 billion, and 270 acquisitions with disclosed deals totaling $14.1 billion.

U.S. stock listings are on the decline. In 1995, there were around 8,000 U.S. listings. Today, there are around 5,000. Meanwhile, the number of listing on non-U.S. exchanges has increased from around 23,000 in 1995 to over 40,000 today.

Exchange listings help companies raise capital, both directly and indirectly. In addition to selling shares, exchange trading establishes a fair transparent price for a company. A company that has a clear price and many potential buyers will attract further investors and lenders to help them fund growth.

It is well recognized that companies that do not trade on exchanging are valued at a discount. Financial experts, the U.S. IRS, the SEC and courts, recognize that discounts for lack of marketability range from 30 percent to as high as 75 percent. A company valued 30 percent or more below its true value will not be able to invest, grow, or create jobs as quickly. Plainly stated, the higher the number of bidders for an asset, the higher the sales price.

Academic research has estimated that between 2000 and 2005, a $50 billion drop in foreign IPOs on U.S. markets cost the U.S. $3.3 billion in lost annual trading-related revenues for U.S. brokers. These revenue losses mean jobs in financial services and related industries, and are moving from the United States to foreign markets.

In any free market society, the number one source of job creation is entrepreneurship. Canada, the United Kingdom, and Sweden have successful venture markets with significant numbers of listed companies and substantial capital-raising success. These markets list hundreds of small companies that create jobs at a fast rate. Venture market companies regularly grow and then graduate to the main markets in those countries.

The United States has no equivalent U.S.-supported and U.S.-organized venture market. NASDAQ OMX has received approval to create such a market on the former Boston Stock Exchange. The companies listed on BX will be smaller companies and the availability of the BX market will facilitate their ability to raise capital to continue and expand their business, creating jobs and supporting the U.S. economy.

In conclusion, we would also like to quickly address the regulator barriers for IPOs. We ask the SEC be open to market-based solutions to create competitive solutions to market problems. We also think that Sarbanes-Oxley reform is critical as we go forward to help small companies go public and remove some of the impediments to their ability to go public.

Thank you for inviting me to testify. I look forward to responding to your questions.

[The prepared statement of Mr. Noll follows:]

NASDAQ OMX

Testimony of Eric Noll
Executive Vice President, NASDAQ OMX Group
Before the House Committee on
Government Reform and Oversight

November 15, 2011

Thank you Chairman Davis, Ranking Member Quigley. My name is Eric Noll and I am the Executive Vice President of NASDAQ OMX Group in charge of NASDAQ Transaction Services United States. On behalf of the NASDAQ OMX Group I am pleased to testify regarding roadblocks in our public markets that prevent job creation.

Forty years ago NASDAQ introduced the world to electronic trading which is now the standard for markets worldwide. In our early years, we gave growth companies the opportunity to raise capital that wasn't previously available to them. Those companies (Intel, Microsoft, Apple, Cisco, Oracle, and Dell, to name a few) used the capital raised on The NASDAQ Stock Market to make the cutting edge products that are now integral to our daily lives. These companies have also created millions of jobs around the world along the way.

Today, the NASDAQ OMX Group owns and operates 24 markets, 3 clearing houses, and 5 central securities depositories, spanning six continents. Eighteen of our 24 markets trade equities. The other six trade options, derivatives, fixed income, and commodities. We are the largest single liquidity pool for US equities and the power behind 1 in 10 of the world's securities transactions. Seventy exchanges in 50 countries trust our trading technology to power their markets, driving growth in emerging and developed economies.

At NASDAQ OMX, we believe the challenges that we face in today's equity markets around liquidity and capital formation can be characterized as the following four items:

1.) Market Structure weaknesses and their concurrent effect on price discovery.
2.) A lack of regulatory focus on rules and trading venues that would assist in the development of a vibrant small growth company environment.
3.) Regulatory barriers to small and mid-cap companies that impede the IPO process and raise the costs of being public for those companies.
4.) Development of H-1B and other immigration reforms to assist companies in their internal hiring and growth plans.

We believe that addressing these issues is critical for generating job creation and growth in the U.S. economy.

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Equity Market Structure Does Not Support the Engine of Job Growth:

Today's U.S. markets, the engine of economic growth, are increasingly fragmented and volatile. Liquidity in US stocks is dispersed across 13 exchanges and over 40 other execution venues. The declining cost of launching and operating electronic order crossing systems has led to a proliferation of decentralized pools of liquidity that compete by offering the owner and customers reductions in fees, obligations, transparency and order interaction.

Nearly one-third of public company stocks trade 40% to 50% of their volume away from the organized exchanges. In the past 2 years the percentage of U.S. market share traded in systems that do not post their bids and offers rose from 20% to over 30%. Many retail and core investor orders are executed away from the primary exchanges.

While we identify market fragmentation as a source of some of the issue in regards to capital formation in the US, there have been many benefits of that fragmentation - they have reduced investors costs and improved execution quality in already listed securities. Additionally, they have spurred technological and market structure innovation in the marketplace which has real benefits for investors. However, the unintended consequences of the market fragmentation has been a lack of liquidity and price discovery in listed securities outside of the top 100 traded names and a disturbing absence of market attention paid to small growth companies by all market participants including exchanges.

Such fragmentation of trading creates a thin crust of liquidity that is easily ruptured, as occurred on May 6th. From the SEC "Flash Crash" report: "The Commission has noted that absent extraordinary conditions such as those occurring on May 6, 2010, retail orders are generally executed by internalizers away from exchanges and without pre-trade transparency, exposure or order interaction." Fragmentation and current market structure raises investor costs. In 2010, the US, which has perennially ranked first globally for institutional investor costs, fell to fourth in the world, behind Sweden, Japan, and France.

Although recent market volatility has led to a slight movement towards exchange markets, trading in shares of public companies on these private trading systems, accounts for more volume than on NASDAQ and the NYSE combined. Price discovery and available transparent liquidity are essential parts of vibrant market systems. James Brigagliano, former Acting Head of Trading and Markets for the SEC has stated that anything that "significantly detracts from the incentives to display liquidity in the public markets could decrease that liquidity and, in turn, harm price discovery and worsen short-term volatility."

Just as our markets continue to evolve and adapt so must the regulatory structure of our markets. We need to strengthen regulation by modernizing systems and increasing transparency to regulators. We support the development of a consolidated audit trail with real time market surveillance and new regulatory tools to help regulators keep pace with technology advances and other changes in the markets.

While we recognize that there are situational benefits and value to some orders being internalized, whenever possible, public price discovery should be encouraged to ensure a robust and balanced marketplace. Internalization serves an important role at times and in those situations should be encouraged -- when a customer can get price improvement, can minimize market impact for larger institutional orders or can contribute to price discovery by posting prices at the NBBO. That said, we must also ensure there is ample liquidity contributing to the critical role of price discovery. Transparency is critical to efficient markets. NASDAQ supports the SEC's proposals to include actionable items of interest within the definition of bids and offers; to move towards a presumption in favor of visible liquidity; and to establish post-trade transparency for dark executions. Modifications to the market data revenue allocation formula could also emphasize the value of public quotations.

Venture Companies Need a Home in the Capital Markets – On an Exchange Platform:

Between 2003 and 2007, the amount of capital raised by private equity funds increased by 300% according to the Private Equity Growth Capital Council. Issuing private equity allows companies to avoid the disclosure and governance obligations created to protect investors. Additionally, the economic slowdown that began in 2008 has depressed interest rates, making bank lending a relatively more affordable source of funding for business expansion.

Few IPOs have been consummated despite an increasing number of companies reaching the stage where a deal is appropriate. 2008 and 2009 were the worst years for IPOs since at least 1980. In 2009, there were just 12 venture-backed IPOs raising $1.6 billion and 270 acquisitions with disclosed deals totaling $14.1 billion.

According to a recent joint survey by Deloitte and the National Venture Capital Association, difficulty in exiting an investment either through sale or IPO is the number one problem facing venture capital. The problem is thought to be the most severe in the U.S.

U.S. stock listings are on the decline. In 1995, there were around 8,000 U.S. listings. Today, there are only around 5,000. Meanwhile, the number of listings on non-U.S. exchanges has increased from around 23,000 in 1995 to over 40,000 today.

Exchange listing helps companies raise capital both directly and indirectly. In addition to selling shares, exchange trading establishes a fair and transparent price for a company. The amount of capital investors and lenders are willing to commit depends on a company's value and marketability. A company that has a clear price and many potential buyers will attract further

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investors and lenders to help them fund growth. A company that has exchange-traded shares can use its stock as a currency to grow its business and incent employees.

It is well recognized that companies that do not trade on exchanges are valued at a discount. Companies that do not trade on exchanges must establish their value through ad-hoc valuation and opaque negotiation. Few potential investors can bid for private companies. Financial experts, the US IRS, SEC, and courts, recognize that discounts for lack of marketability ranges from 30% to as high as 75%. A company valued 30% or more below its true value will not be able to invest, grow and create jobs as quickly. Plainly stated; the higher the number of bidders for an asset, the higher the sales price. A healthy public equity market enables companies to raise capital more efficiently, funding more rapid growth and more jobs.

The fastest growing listing markets in the world are also the least fragmented. Using a popular scale of fragmentation, the unfragmented Hong Kong Hang Seng Index scores a 1 whereas the U.S. S&P 500 trails developed markets with a score of 4.5, meaning an order has to visit 4.5 markets to achieve best execution in the U.S. but only 1 in Hong Kong. Hong Kong saw 60% growth in the value of its IPOs each year between 2001 and 2007.

While IPO activity has increased since the end of the recession, there remain significant concerns about the long term health of the IPO market. The IPO market affects the long term health of the overall economy.

Public companies generate revenues from trading, research, and other brokerage activities. IPOs generate substantial underwriting fees for accountants, bankers, and lawyers as well as jobs in public relations and other IPO related industries. Academic research has estimated that between 2000 and 2005, a $50B drop in foreign IPOs on U.S. markets cost the U.S. $3.3 billion in lost annual trading related revenues for U.S. brokers. These revenue losses mean jobs in financial services and related industries are moving from the U.S. to the foreign markets.

According to data gathered by Renaissance Capital, in 2010 IPO issuance from the Asia-Pacific region – particularly China, Hong Kong, India and Japan – accounted for almost two-thirds of global capital raised. North America lost share, falling to 16% of global proceeds, the lowest share for North America on record. Were it not for the renewed GM IPO, North America's market share would have fallen to a pitiful 10%.

In any free market society the number one source of job creation is entrepreneurship. Very much the way business incubators nurture small companies until they are ready to leave the security of that environment and operate independently, there is a space for incubating small public companies until they are ready to graduate to a national listing. The U.S. must create a space for these markets just as our foreign competitors have successfully done.

Canada, the United Kingdom, and Sweden have successful venture markets with significant numbers of listed companies and substantial capital-raising success. These markets list hundreds of small companies that create jobs at a fast rate. Venture market companies regularly grow and then graduate to the main markets in those countries. The U.S. has no equivalent exchange-supported, organized venture market.

According to the London Stock Exchange, The London AIM Market has been one of the fastest growing markets in the world for the last decade. They have listed over 1,200 listed companies, including 234 international listings; including some American firms. 141 AIM Market listings have graduated to LSE's main market.

In just five years, the Swedish First North Market, run by NASDAQ OMX has grown to 141 listings with a total capitalization of 2.8 billion Euros. 22 First North companies have graduated to the main market since 2006.

The Toronto Stock Exchange Venture Exchange may be the most successful of these venture markets. 2,100 companies with a total market cap of $37.8B, with a median cap of $4.2 million have listed on the Toronto Stock Exchange Venture Exchange. 451 TSX Venture Exchange companies have graduated to the Toronto Stock Exchange since 1999. Graduates account for more than $87B in market capitalization. 15% of Toronto Stock Exchange companies with a market capitalization greater than $1B are TSX Venture Exchange graduates.

BX Venture Market can be the Home for Small Companies to Access the Capital Markets:

The NASDAQ OMX Group has received approval to create a new listing venue on the former Boston Stock Exchange. The companies listing on BX will be smaller companies and the availability of the BX market will facilitate their ability to raise capital to continue and expand their businesses, creating jobs and supporting the U.S. economy.

The BX Venture Market will have strict qualitative listing requirements, similar to other exchanges, but lower quantitative standards that would attract smaller, growth companies. Under our Qualitative Listing Standards companies must: be registered under Section 12 of the Exchange Act; be current in periodic filings; have a fully independent Audit Committee; have independent directors make compensation decisions for executive officers; comply with the Voting Rights Rule; hold independent director executive sessions; use an auditor registered with the PCAOB; obtain shareholder approval for the use of equity compensation; hold an annual shareholders' meeting; and comply with all requirements of Sarbanes-Oxley. BX will also conduct a public interest review of the company and significant associated persons.

NASDAQ OMX

Under our Quantitative Listing Standards companies must have: an initial listing price of $0.25 for companies previously listed on a national securities exchange or $1.00 for all others; a continued listing price of $0.25; 200,000 publicly held shares for initial and continued listing; 200 public shareholders for initial and continued listing; $2 million market capitalization for initial listing and $1 million for continued listing. Companies not previously on an exchange will have to meet additional balance sheet requirements and have at least a one-year operating history.

The BX Venture Market will provide a well-regulated listing alternative for companies that otherwise would transfer to, or remain on, the largely unregulated Pink Sheets or OTCBB, where there are no listing requirements, no public interest review, limited liquidity, and limited transparency, or list on junior tiers of non-US markets.

While we are certain this Venture Exchange is needed, we also believe that innovative trading rules are required to make the market successful. Small companies do not trade like Microsoft, Intel, Apple or Oracle. As you look at the trading behaviors of small companies in this range, building and maintaining liquidity is a constant challenge. Thus, this exchange needs new incentives for market makers to pledge their capital for these stocks, needs market structure protections that can be built-in to allow trading in these stocks to flourish, needs new thinking about issues like tick sizes and unlisted trading – "Nothing v*entured*, nothing gained" has real resonance on these issues in a very literal sense.

Remove Regulatory Barriers for IPOs:

We also ask the SEC to be open to market based solutions put forward by NASDAQ OMX and other exchanges to create competitive solutions to market problems.

The U.S. environment for IPOs is being viewed as less inviting. Where litigation and market fragmentation are certainly factors, Sarbanes-Oxley has become the catch-all term for regulatory hurdles to going public in the U.S. Although Sarbanes-Oxley has improved investor protections that contribute to the U.S. reputation for having the safest, best regulated, markets in the world, it has equally added to the financial obstacles that small and medium sized companies are reluctant to hurdle. The result is less foreign and small domestic companies opting for a U.S. public listing. The President's Jobs Council found that Sarbanes-Oxley was a key factor in reducing the number of IPOs smaller than $50 million from 80 percent of all IPOs in the 1990s to 20 percent in the 2000s. The Committee on Capital Markets Regulation has observed that "willingness of U.S. companies to do their IPOs abroad is a strong indication of their concern with the burdens of the U.S. public market."

NASDAQ OMX

Nearly a decade after its passing, it is time for subject matter experts and policy makers to review the requirements of Sarbanes-Oxley and its' effects on capital formation and propose changes that will maintain its safeguards while easing its financial burdens. There are several viable proposals that should be considered:

- **Make Section 404(B) a bi-annual rather than an annual event**. Once a public company completes an initial, broad audit, reduce the frequency of the audits to biannual – particularly for companies that pass their Sox audit with no material weaknesses. Any controls that are changed or fail in the previous audit should be retested the following year.

- **Consider increasing the size of the smaller public company exemption**. NASDAQ applauds Congress' codification of the SEC's practice of exempting public companies under $75 million dollars in market capitalization. However, we feel that this should be higher and the recommendation of the President's Job Council to increase the exemption to $1 billion should be considered. I understand the House Financial Services Committee is considering legislation in this area and working to get an exemption passed in the $350 million range. This is a positive, but somewhat more limited exemption and I hope they can go higher to match President Obama's call for a $1Billion exemption.

- **Implement a time or size grace period for new public companies**. New public companies can be temporarily exempted from Sarbanes-Oxley requirements for either a specified number of years or until they reach a specific market capitalization; whichever comes first.

- **Reject Expensive and Expansive New Regulations on Public Companies:** Policy makers and regulators must also be careful about imposing new regulations that lack necessity, yet will raise a public company' costs. For example a recent PCAOB proposal would require public companies to rotate auditors. Public companies and auditors both agree that this proposal will raise public companies' cost by eliminating efficiencies created through established relationships in which auditors retain knowledge of public companies they audit. In 2005 after the PCAOB was created, a hearing was held in the House Financial Services Committee and then Chairman William J. McDonough was asked about the viability of required auditor rotation. Chairman McDonough rejected it as a requirement due to potential problems of auditor independence.

Create Jobs by allowing Companies to Hire the Employees They Need:

I just mentioned how entrepreneurship is the greatest source of job creation in a free market society. It follows that the greatest source of entrepreneurship is human innovation. The United States achieved its economic prominence by inviting the best and the brightest from around the globe to unleash their creative capabilities on American soil and contribute to the American mosaic, culturally, politically and economically. Immigrants have been some of the greatest contributors to business, science and technology in American Society. 25% of technology and engineering companies from 1995 to 2005 had at least one immigrant key founder.

NASDAQ OMX

Over one decade, immigrant founded ventures created 450,000 jobs and represented a market capitalization of roughly $500 billion. One out of three Ph.D. candidates in science and engineering are foreign born. More than 50% of advanced degree graduates from U.S. universities in the STEM disciplines are foreign nationals.

Our economy and NASDAQ itself have directly benefited from the contributions of foreign-born talent. Looking just at the Fortune 500 companies, we found at least 14 active NASDAQ companies that have foreign-born original founders. These companies represent over $522 billion in market capitalization and employ almost 500,000 workers.

Legal immigration is a source of economic growth in the United States and I am concerned that its' continued entanglement in the illegal immigration debate will only exacerbate our already anemic economy. Every year we send approximately 17,000 STEM graduate students back to their home countries after educating them here in the finest universities in the world. It is critical that we reform our immigration system to accommodate these graduates. If U.S. companies cannot hire them here, they will hire them for the same job overseas. Therefore, I recommend the following to the U.S. Congress:

- ***Debate Legal Immigration on its own merits:*** Do not link *legal* reform to reform of *illegal* immigration – Americans are losing jobs and opportunity while one issue drags down the other. American workers, with good jobs, cluster around these highly-skilled workers. Achieving a comprehensive solution will take years – years Americans who need jobs do not have.
- ***Enact a more flexible and stable regime for Legal Immigration***: Reform must convey economic priorities about job growth and global competitiveness. Increasing H-1B numbers is no longer enough. We need to admit and keep entrepreneurs here so that the creative dynamism of our marketplace has the very best skills and minds. The default should be "yes," not "no."
- ***Attack the "job stealing" myth directly:*** Opponents of Legal Immigration reforms argue that when a foreign born immigrant gets a job, American graduates are the losers. Research tells a different story. The National Federation for American Policy says that for every H-1B worker requested, U.S. technology companies *increase* their employment by five workers.

Thank you again for inviting me to testify. I look forward to responding to your questions.

Mr. McHenry. Mr. Mecane.

STATEMENT OF JOSEPH MECANE

Mr. Mecane. Chairman McHenry, Ranking Member Quigley and members of the subcommittee, I want to thank you for inviting NYSE Euronext to discuss whether new and smaller public companies suffer from liquidity issues as a result of our current market structure and whether the current structure contributes to a lower level of IPOs.

I intend to focus my attention on three main topics. First, I will focus on the importance of liquidity for companies with small market capitalizations and a proposal we believe may help small-cap issuers. Second, I will discuss liquidity fragmentation in the marketplace. And last, I will address the subcommittee's question regarding liquidity payments to market makers.

Before I jump into the points previously outlined, I would like to give some background about smaller issuers and why it is important to focus on this segment of the market. Small- and medium-sized enterprises, so-called SMEs, are the backbone of the American economy, and in previous economic downturns entrepreneurs and small businesses have been the main source of job creation. In fact, 18 of the 30 Dow Jones Industrial Average companies were founded during economic downturns.

However, in order to enable SMEs to reach their full potential, capital must be easily accessible. In that effort, NYSE Euronext has been vocal in its support for Congress to adopt legislation to increase the threshold for Regulation A offerings as well as to adopt a larger exemption for SMEs from Sarbanes-Oxley, section 44-B. Each of these and other efforts are with a keen eye toward not only capital formation, but also job creation, which increases significantly as companies move through the capital formation process. To echo some of the remarks by Chairman McHenry at the beginning, over 90 percent of jobs in a company are created after a company goes public.

There is one reason that liquidity is so vital for new and smaller issuers. Companies with small capitalizations consistently raise two concerns about going public as it relates to market structure. First, whether there will be sufficient liquidity in my stock; and second, will I have sufficient analyst coverage?

As the Securities and Exchange Commission recognized in its 2010 concept release on equity market structure, small-cap stocks can and often do trade differently than large-cap stocks. In particular, we have observed less liquidity at the national best bid and offer for small-cap stocks which we believe may be hampered by too narrow of a spread increment of a penny. While narrower spreads are generally a very positive result for investors, we believe that a penny minimum tick size may counterintuitively reduce the amount of liquidity at the best price, thus resulting in smaller quoted sizes and thinner markets.

Accordingly, NYSE Euronext has advocated that a market-wide pilot with wider spread increments for less liquid securities could be a worthwhile exercise. During the pilot period, market participants and the Commission can review data to determine whether the impact is providing added investor benefits to less liquid securities. This could help increase the appetite for research coverage which declined after the global research settlement, and should be combined with a separate review of the restrictions around IPO communications.

Liquidity concerns for emerging growth companies transcend the public markets with volumes fragmented across multiple exchange and non-exchange venues. While we believe that competition has been a positive factor for the marketplace, we have noted that the level of off-exchange participation in less liquid stocks is frequently above average. However, price discovery is dependent on interaction among a diverse set of market participants.

In this vein, we have recently filed for approval of our newly created Retail Liquidity Program. This program will allow for superior execution prices for retail investors and encourage additional price competition for retail orders from liquidity providers, and we believe this program could help consolidate and potentially increase the liquidity in less liquid securities.

Finally, the committee requested comment regarding what if any additional incentives could be adopted to incent market makers to post liquidity in less liquid stocks, including the allowance of issuers to pay market makers to provide liquidity directly. The committee has discussed the creation of a program where small-cap companies could enter into agreements directly with broker-dealers. NYSE Euronext believes the idea discussed warrants further review from both FINRA and the SEC and it is a topic that we have been separately pursuing. We would note, to echo Chairman McHenry's comments, that this is a process that exists in Europe and has shown beneficial effects on the liquidity of smaller issuers.

In closing, NYSE Euronext believes that Congress and the appropriate regulatory authorities should work together with the industry to identify appropriate steps that can be taken to increase the level of liquidity for smaller public companies. Even if only on a pilot basis, trying new things will allow the market to determine which approaches could have the greatest impact on increasing the level of liquidity in illiquid stocks.

Jobs are the number one issue facing our Nation, and although only part of a broader solution, we believe that adopting some of the approaches previously outlined will have a positive impact in reversing some of the negative trends we have recently seen.

Thank you for the opportunity to present.

[The prepared statement of Mr. Mecane follows:]

Testimony of
Joseph Mecane, EVP and Co-Head of U.S. Listings and Cash Execution
on behalf of NYSE Euronext
before the
U.S. House of Representatives
Committee on Oversight and Government Reform
Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs

"How Roadblocks in Public Markets Prevent Job Creation on Main Street."

November 15, 2011

Chairman McHenry, Ranking Member Quigley and members of the Subcommittee, I want to thank you for inviting NYSE Euronext to discuss whether new and smaller public companies suffer from liquidity issues as a result of our current market structure and whether the current structure contributes to a lower level of IPOs.

NYSE Euronext (NYX) is a global exchange operator with 7 equities exchanges (3 U.S. and 4 Europe) and 8 derivatives exchanges (3 U.S. and 5 Europe). Although market structure rules in each country have their own nuances, NYX is able to educate itself about and compare each country's business and market models to learn from the experiences of our European colleagues and market participants. In the U.S., our NYSE Amex listings venue, which is the former American Stock Exchange, is targeted specifically at emerging growth companies and creating an investor-friendly environment for smaller companies to go public.

In accordance with the invitation we received from the Subcommittee, we intend to focus our attention on three topics we believe are relevant to improving liquidity in smaller public companies. First, we will focus on the importance of liquidity for companies with small capitalizations (small cap stocks) and a proposal we believe may help small cap issuers. Second, we will discuss liquidity fragmentation in the marketplace and lastly, we will address the Subcommittee's point regarding issuer payments to market makers.

Before I jump into the points outlined above, I'd like to give some background about smaller issuers and why it's important to focus on this area of the market. Small and medium size enterprises (so-called SMEs) are the backbone of the American economy and in previous economic downturns, entrepreneurs and small businesses have been the main source of job creation. In fact, 18 of the 30 companies in the Dow Jones Industrial Average were founded in economic downturns.[1] These SMEs have the effect of creating local jobs and subsequently, local economies experience growth as the companies expand locally. This in turn stimulates national and international economic growth as the companies continue to succeed.

However, in order to enable SMEs to reach their full potential, regardless of whether the source of the capital is from friends and family, venture capitalists or the public markets, capital must be easily accessible. As access to capital is eased at the lower end of the business growth chain, the likelihood becomes greater that a small business can hire more employees, expand its revenue base and eventually become a publicly-traded enterprise. In addition to looking for opportunities to bring greater

[1] http //www.kauffman.org/uploadedFiles/american-02-06-09-end-of-american-capitalism.pdf

levels of liquidity for already public companies, NYSE Euronext has focused on ways to relieve some of the hurdles small businesses face by offering solutions designed to ease the ability for these businesses to grow. In that effort, NYSE Euronext has been vocal in its support for Congress to adopt legislation to increase the threshold for Regulation A offerings as well as to adopt a larger exemption for SMEs from Sarbanes-Oxley Section 404(b). Each of these and other efforts are with a keen eye toward not only capital formation but also job creation which increases significantly as companies move through the capital formation pipeline. In fact, according to data collected by IHS Global Insight, 92% of jobs in a company are created after a company goes public[2], highlighting the importance of ensuring that when a company makes the leap to becoming public, the equity market structure in place incents investors to provide smaller companies with sufficient levels of liquidity support during that critical transition.

The Case for Wider Spreads

This is one reason that liquidity is so vital for new and smaller issuers. Companies with small capitalizations consistently raise two concerns about going public as it relates to market structure: will there be sufficient interest in the company's stock and secondly will there be sufficient analyst coverage of the stock to attract long-term investors. These two concerns highlight the reason both short-term liquidity providers and long-term investors are necessary to provide SMEs with the capital they need to grow their companies, while maintaining an investor's confidence that they will have the ability to exit their positions with ease if desired.

As the Securities and Exchange Commission (Commission) recognized in its 2010 Concept Release on Equity Market Structure[3], small cap stocks can – and often do -- trade differently than large cap stocks. One area of concern is whether the current market structure itself, which treats all stocks similarly, impacts small cap stocks in an adverse manner. In particular we have observed less liquidity at the National Best Bid or Offer (NBBO) for small cap stocks, as well as less Exchange activity in less-liquid securities, which we believe may be hampered by too-narrow of a minimum tick size, currently $0.01. While narrower spreads are generally a positive result for investors, especially in more liquid securities, we believe a $0.01 minimum tick size for low-cap stocks may counter-intuitively create a disincentive to provide liquidity at the best price, resulting in smaller quoted sizes and thinner markets.

It is possible that deeper liquidity in smaller cap stocks as a result of wider spreads may lead to additional volume. And with additional volume and investors, there may come increased analyst coverage.

Accordingly, NYSE Euronext has advocated that a market-wide pilot program with wider spread increments for less liquid securities could be a worthwhile experiment. During the pilot period, market participants and the Commission can review data to determine whether the impact is providing added investor benefits to less-liquid securities. A pilot program would also provide the Commission with additional data that can be utilized in a cost benefit analysis should the Commission decide to make the pilot permanent.

NYSE Euronext also believes there is a general need to improve the availability and flow of information for investors before and after an IPO. As detailed in a recent industry IPO Task Force report presented

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[2] Venture Impact Study 2010 by IHS Global Insight.
http://www.nvca.org/index.php?option=com_content&view=article&id=255&Itemid=103.

[3] SEC Concept Release on Equity Market Structure. http://www.sec.gov/rules/concept/2010/34-61358.pdf

to the U.S. Treasury Department and Congress[4], we believe another effective way to bolster liquidity is to improve the flow of information to investors about new and small cap companies by increasing the availability of company information. This could partly be achieved through a review and attenuation of the restrictions on analyst communications and quiet periods.

Liquidity Fragmentation

Liquidity concerns for emerging growth companies transcend the public markets. We believe that competition has been a positive factor for the marketplace, and having diverse market models has led to many beneficial market structure developments for investors. We additionally believe that internalization has resulted in positive trading experiences for retail investors.

However, we have noted that the level of off-Exchange participation in less liquid stocks is frequently above-average, often exceeding 40% of trading activity[5]. Some of this is a result of higher proportional retail participation in these types of stocks; some is also a result of the wider spreads in these names and increased dark pool activity. However, price discovery is dependent on order interaction among a diverse set of market participants, including short-term, long-term, retail, and institutional investors.

NYSE Euronext supports the Commission's effort to assess the current market environment and update market structure regulations to address the impacts of market dispersion and fragmentation. In this vein, we have recently filed for approval of the Retail Liquidity Program. This program, which would be for NYSE and NYSE Amex traded securities, will allow for superior execution prices for retail investors and encourage additional price competition for retail orders from liquidity providers. We believe this program could help consolidate the liquidity on exchanges in less liquid securities.

Market Maker Incentives

Finally, the Committee requested comment regarding what, if any, additional incentives could be adopted to incent market makers to post liquidity in less liquid stocks, including the allowance of issuers to directly pay market makers to provide liquidity in the issuer's stock. On our 3 US equity markets, the primary incentives that broker-dealers receive to act as market makers are favorable economics for meeting our market maker liquidity and quoting requirements throughout the course of a month.

However the current financial incentives provided to market makers in the broad market have not always guaranteed liquid markets in all securities, including those small capitalization securities that the Committee is focused on, and there may not be sufficient economics even available from Exchanges. As a result, there should be additional thought given to what incentives or advantages through rule-making or economics could contribute to a greater level of liquidity in small capitalization stocks. As recommended by a group of market makers who commented to the SEC's Concept Release[6], the Commission could consider stronger market maker obligations such as best price obligations, depth

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[4] Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth, page 26. www.nvca.org.
[5] NYSE Euronext internal data analysis.
[6] Comment Letter from GETCO, LLC; Virtu Financial, LLC; and Knight Capital Group, Inc. http://www.sec.gov/comments/s7-02-10/s70210-255.pdf

obligations or any of the number of recommendations outlined in the letter. Here again, these changes would need to be coupled with commensurate benefits to liquidity providers.

The Committee has discussed the creation of a program in which small cap companies could enter into agreements directly with broker-dealers or through exchanges to provide direct payments to a broker-dealer who agrees to make a market in the issuer's security. Although FINRA rules adopted in 1997 prohibit any direct or indirect payment by an issuer to a market maker, NYSE Euronext believes the idea discussed may warrant further review by both FINRA and the SEC, and is a topic that we have been pursuing. We would also note that this is a process allowed in Europe and academic research has shown beneficial effects on the liquidity of smaller issuers.[7]

In closing, NYSE Euronext believes that Congress and the appropriate regulatory authorities should work together with industry to identify appropriate steps that can be taken to increase the level of liquidity for smaller public companies. Even if only on a pilot basis, trying new things will allow the market to determine which approaches could have the greatest impact on increasing the levels of liquidity in illiquid stock. Jobs are the number one issue facing our nation and although only part of a broader solution, we believe that adopting some of the approaches outlined above will have a positive impact in reversing some of the negative trends we have recently seen. I would also refer you to NYSE Euronext's 7th annual CEO report for more information about the thoughts of CEOs around the world regarding job creation and economic growth. The report can be found on our website at www.NYSE.com.

I appreciate having had the opportunity to present to the Committee today and am happy to answer any questions you might have.

[7] Johannes A Skjeltorp and Bernt Arne Odegaard (2011). "Why do listed firms pay for market making in their own stocks?"

Mr. McHENRY. I certainly appreciate your testimony. This is very helpful and instructive.

I want to begin this way. There is a lot of discussion about what our public markets actually do and it is missed on a lot of individual Americans what the public markets are really all about. So I want to ask you, what net benefit do you provide to society through your exchange, through the public markets? I will just begin there. Mr. Noll?

Mr. NOLL. I think we provide several. The first one is what I will call the ability to discover prices for assets. So if a key tool for investors of all types, retail and institutional, is to understand the real value of an asset that they are investing in and the willingness to risk their own capital by investing in that, understanding the true price of that underlying asset is critical. So the ability of exchanges to discover that price for all investors on a fair and transparent way where everyone has access to that same price is critical for the determination of the underlying value of those assets.

Linked to that price discovery formation is what I will call liquidity discovery. So just as important as discovering the price, is the size at which I can transact at. So exchanges perform a valuable function in gathering together all of the available buying and selling interest that is out there so that investors not only can discover price, but they can discover the size in which they can transact at, at that price.

Ultimately that price discovery and that liquidity discovery enables companies not yet public to help themselves determine how they will be valued when they become public and provide a framework and a platform in which they can in fact bring their asset forward, attract investor interest, and see the liquidity in that investor interest develop and therefore raise prices to create jobs and grow their own businesses.

So if I were to summarize, those are the big three that I think add value from the exchange side.

Mr. McHENRY. Mr. Mecane?

Mr. MECANE. I will echo Mr. Noll's comments. I will also add that one of the primary purposes of an exchange are to match companies who are looking to raise capital in a public venue with potential investors who may look to invest in that company, help it grow and expand.

Clearly companies that do want to go public or want to raise capital have a number of different options that they can pursue in order to do that. They can look to private investors and do a private capital raise. They can look to be acquired, either through a traditional M&A transaction or through a private equity or venture capital-type transaction, or they can choose to raise capital in a public format.

Obviously the theme of this panel is talking about why companies may choose to go one of those other routes instead of going the public company route, and that is obviously a complex question, but I would view that last piece as being the primary responsibility of a public market.

Mr. McHENRY. With IPOs, it is about accessing capital in order to grow your business and it is a choice that you described, Mr.

Mecane, between the various options. Many small businesses put it on a credit card to get started or get a loan. Probably not right now. They probably put it on their credit card more so. And then once they grow, they can get to the stature by which they can go to the public markets to access capital to more fully grow their business and take leaps and bounds. It also provides investors, individual small mom-and-pop investors, the average American, to access this type of equity-side upside benefit of companies going public.

I think it is important to begin there, because a lot of discussion about financial service products right now isn't related right back to what their net benefit is. It isn't a benefit as a product, it is a benefit of price discovery and accessing capital to grow a business.

So I wanted to begin there. I would hope that we can come back for other rounds of questions. But with that, I would like to recognize Mr. Quigley for 5 minutes.

Mr. QUIGLEY. Thank you, Mr. Chairman. It is interesting the chairman brought this up to the 30,000-foot level. Sometimes we have questions that are more specific. I guess I would like to ask a specific question, but then get back to a larger 30,000-foot perspective.

My initial question had to do with Mr. Mecane. In your written testimony I think the quote is, "Although the FINRA Rules adopted in 1997 prohibit any direct or indirect payment by an issuer to a market maker, NYSE Euronext believes the idea discussed may warrant review by both FINRA and the SEC and it is a topic we have been pursuing." Obvious concerns are because the rule in the first place dealt with manipulation, it dealt with the potential that executives of a company are incentivized to have their stock valued very high so it creates an opportunity for inappropriate activities.

That question, and I would like you to both address it, really gets to the core of the issue here with what we try to do here. Put yourself in our place. What we are really dealing with for yourselves and for ourselves is faith and trust both with the American public and with potential investors. Investors have to have faith that there won't be a manipulation, but also the larger issue of giving you the opportunities to do what needs to happen to create jobs when the American public still has a gaping hole in faith and trust.

Can you address that as a larger issue?

Mr. MECANE. Sure. It is a very good point, and we echo your concerns about ensuring that investors have full faith and confidence in our public markets. Part of why my words were chosen carefully is because I don't think it is a very straightforward topic, and there are different sides to the same equation.

The reason the restriction was originally put in place was to avoid exactly the point that the Congressman raised, that there is a conflict inherent in a situation where a company itself is paying a liquidity provider to make a market in the stock. So it is part of why, while we believe it may be a worthwhile discussion and experiment to try, it would need to be done in a way where there was sufficient disclosure and discussion around the conflict itself and whether it could be addressed.

When I specifically stated that it is an avenue that we have been pursuing separately, part of our thought—and where we have been looking at this as an opportunity—is specifically in the ETF market. While that is not a topic of this committee, it is relevant because with ETF products, which are generally linked back to the underlying securities, there is less opportunity for manipulation because there is an arbitrage between the ETF price and the stock price.

My point is that one avenue to try is an experiment specifically with ETFs with this type of a program to see if it actually helps with liquidity in those names, and that could then give more support and documentation as to whether it would be worth trying in the public markets also. So it could be done in a two-step process to try and minimize the conflict that you raised, Congressman.

Mr. NOLL. Thank you, Congressman. Like the New York Stock Exchange, this has been an issue that we have been paying attention to for a while. NASDAQ OMX in Stockholm operates a market called True North which is a venture market in which market makers do receive payments from issuers, and we have seen some great success in that platform in developing liquidity in the Nordic markets.

Here in the United States, I think our concerns are echoed by you and by the New York Stock Exchange that the ability to create conflict or have conflicts in this area is something that we have to be very careful about. We are proposing, not unlike the New York Stock Exchange, to come forward with our own set of rules around this kind of process. One would be for our BX venture market in which we would create a structure by which the exchange in an open and transparent way would collect payments from issuers and then use them to provide to market makers to provide liquidity. So we are preparing a rule filing now to submit to the SEC that would allow us to do that.

I think it brings two very good benefits to us by doing that, not only to us but to the marketplaces. One is that it is a rule set that would be transparently argued, debated, and approved by the SEC, and therefore monitored by them on an ongoing basis and the rules would be available and open to everyone to see and to participate in.

Then I think it would address a problem that this committee has identified, which is that there is a lack of liquidity in these small-cap stocks. And I think it is fair to say and important to say that market makers will respond to economic incentives, so passing a rule that says that market makers need to make markets in small-cap stocks won't add any more liquidity. What will add liquidity to them is creating economic incentives to them to benefit by providing liquidity, and we think that this program will do that.

Likewise, on the ETF side, NASDAQ is preparing a rule filing to do the same thing as well, which is to stimulate market maker interest in less active, less interesting ETFs, or not less interesting, but less followed ETFs to help stimulate liquidity in those as well. And I agree with Mr. Mecane that in both cases I think that these are valuable experiments for the Commission to try.

Mr. QUIGLEY. Thank you.

Mr. MCHENRY. Mr. Guinta, the vice chair of the committee, is now recognized for 5 minutes.

Mr. GUINTA. Thank you very much, Mr. Chairman. Thank you both for coming here today.

In a series of subcommittee hearings that we have been having over the last several weeks, we have been focusing a lot on how to create access to a stronger job market in this country. Obviously, the country is concerned about that primarily, and it has a dramatic effect on just about everything we do nationally and internationally.

My focus is more narrow in scope, and I want to talk a little bit about the IPO market, I want to talk a little bit about the decline of IPOs that we have seen recently in this country, and I want to ask you both to focus a little bit on, number one, why you think we have had a decline in IPOs, where those IPOs are being listed, and what the negative effect of that is in terms of job creation here in America.

Mr. Mecane, if you want to begin.

Mr. MECANE. Sure. Thank you for the question. I will borrow from a report that was recently issued which the committee may or may not have seen, but it is a series of recommendations from the IPO task force which tried to tackle this issue and did, I think, do a good job of generating some data to support the issues that were being discussed.

What seems to be the prevailing trend around the decline in IPOs is specifically concentrated in the smaller part of the market, so the sub-$50-million-type companies, and it does not appear that those companies are not being created or that they are actually going public on other venues. What appears to be the trend is that they are choosing to, when they get to a size where they are at a decision point about what the next step is for them to proceed, they are choosing increasingly to go through a private M&A-type transaction, either being acquired by a larger firm or a private equity-type firm, instead of going the route of the public market.

I would say that has been the very broad trend over the last 20 years, where the first decade of the last 20 years was marked by a very high level of capital issuance by those smaller companies and the last decade of the last 20 years has been marked by more of these private M&A transactions.

Obviously, it is an important question from a job creation standpoint, because as we noted earlier, much of the job creation that does happen in a company's life cycle occurs after they go public when they do have access to all these additional funds to expand their business and to hire and to go into new business lines.

So the question as to why companies are choosing that private route instead of the public route is an important one. It is also, I believe, a complex one with a number of different dynamics occurring simultaneously.

To paint one side of the equation, clearly the private equity and private capital part of the market has become a lot stronger in the last decade, and so some of what we are seeing could just be the evolution of that part of the market and an increasing ability to have another option other than going public. But at the same time, I think it is hard for us to ignore the fact that the cost of going public and the oversight of being a public company, especially for a smaller $50-million to $100-million-type company, has been increased significantly over the course of the last few years.

Obviously it is a balancing act post-Sarbanes-Oxley and other types of reforms to make sure that there is confidence in our companies and willingness of investors to know that the company that they would be putting money into is safe. But at the same time it does call into question whether there are things that we can do to make it easier, less costly, especially for the first few years of a company being public, to be able to go public more easily.

Mr. GUINTA. I want to get to Mr. Noll, but just one final question. Would you agree with the statement that an M&A transaction, rather than an IPO, is missing an opportunity for job creation?

Mr. MECANE. I don't want to over-generalize too much, but I would agree in a lot of M&A transactions the focus tends to be on synergy opportunities as opposed to expansion opportunities, and that is an over-generalization. It is not always true, but I do generally agree.

Mr. GUINTA. Generally speaking, yes.

Mr. Noll, can you just maybe add to what Mr. Mecane said?

Mr. NOLL. Sure. Following up on Mr. Mecane's comments about M&A, which I generally would agree with, I think one of the issues that we are facing as an exchange and as an economy is that when that becomes increasingly the only avenue, it creates limitations on the way companies can grow their business, the way they can ask for capital, and the way they can use that capital to grow their businesses.

So it isn't so much that M&A represents a bad way for companies to grow their business or private equity is a bad way for companies to grow. Quite to the contrary, those are all valid and very good ways to grow businesses. But as the IPO window for those businesses has closed, it removes some of the optionalities for what companies can do in a way that is most ideal for them, so that we become very worried about that and making sure we are developing that market for that small-cap company.

You had asked earlier as well where a company is going. So the small companies are clearly going to the private markets. Foreign issuers, who traditionally had come to the United States to raise capital, are choosing not to list here, and a lot of that is compliance with our Sarbanes-Oxley rules, which may create additional costs for them that they would not like to face. I think the costs of market fragmentation are expensive for them.

It is an interesting day when Manchester United, a very large U.K. sports team, chooses to list its stock on Singapore, and, quite frankly, never considered a U.S. listing. Twenty years ago, they would have come to the United States almost by default. So how we think about those issues I think is important as we go forward.

So I think it is critical that we try to clear up the IPO calendar and the IPO structure for those small-cap companies and those foreign issuers.

Mr. GUINTA. I see my time has expired. I appreciate the chairman's indulgence.

Mr. MCHENRY. All right. Thank you. Now we will begin a second round.

So the bid-ask spreads have tightened, but out of that order flows have gone way up. I mean, the volume has gone way up. That is correct, right? So what does that do for exchange revenue? Does that mean exchange revenue goes up with the order flow? Mr. Mecane?

Mr. MECANE. Sure. I would make two points. One is that there has been two separate dynamics going on in the industry. One is that clearly as bid-ask spreads have compressed, we have seen an increase in volume. But I would also highlight the point that in that same period of time, part of why those two trends happened is because there has been increasingly aggressive competition in the space, and the prices that exchanges and other venues have charged has also declined commensurate or even in excess of the spread decline. So I will just highlight that. Even though there is higher volume, because of those trends we are actually, frankly, making less money than we were in the prior periods.

But it also leads to a second point, which is more specific to the small- and mid-cap part of the market. A lot of the spread compression and increased competition that we have seen has been in the very large liquid stocks where you have seen a lot of algorithmic-type trading, high-frequency-type trading, which tends to narrow the spread and make it very cheap and efficient and fast for the large-cap stocks to trade.

The unfortunate reality is those same trends haven't occurred in the small- and mid-cap part of the market. Those stocks don't have sufficient liquidity for the high-frequency-type automated traders to traffic in those names, and as a result, you have not seen a commensurate level of volume or liquidity or spread compression that you have seen in some of the large-cap names. And that is part of why we have suggested the experiment with perhaps wider spreads, as counterintuitive as that is, for those names.

Mr. MCHENRY. Okay. So there is less revenue of a new listing based on competition.

Mr. MECANE. Correct.

Mr. MCHENRY. Okay. But order flow has gone way up, the volume has gone way up. So part of that is with the spreads compression but with the order flow going up. In those terms, spread compression, order flow going up, have they offset each other roughly?

Mr. MECANE. I think probably, roughly.

Mr. MCHENRY. Roughly. Is that how you see it with NASDAQ?

Mr. NOLL. I do, although I would note that volumes have actually come down in the last year, year and a half. And while I think there is a great deal of truth to the statement that tighter spreads and lower costs have driven volumes up, I think one of the things to remember about volumes and participation in the marketplace, it is ultimately about confidence in the market and it is market structure, and it is also about the ability of investors to transact in an effective way. So we have seen some of that confidence impaired.

Quite frankly, we have seen volumes come down. And some of that confidence isn't necessarily in exchanges or exchange systems, but in the strength of the U.S. economy. So we have seen much higher volume days 2 or 3 years ago than we have in the last year. So while there certainly is a link between low costs and higher volumes, it isn't the only driver for volumes. So I think that is an important thing to know.

Mr. MCHENRY. So order flow is more important than new listings though; is that fair to say, as a business concern?

Mr. NOLL. Well, I think two things about new listings that are critical for us and why we are starting to pay a lot of attention to this sector. One is this is where the new companies are going to come from, and we as exchanges, and particularly at NASDAQ, if we can't get those companies to be public and listed on one of our platforms for trading as they grow up to be big companies and very important companies in the U.S. economy, we won't be performing our function in the way that we hope to be performing it.

Mr. MCHENRY. So therefore your investment on what used to be the Boston exchange.

Mr. NOLL. Right. So the creation of the BX venture market, try to look at market maker structures to try to provide liquidity there, which for us is a long-term investment in the development of new companies, because ultimately we think that is where the future growth is going to come from and we need to participate in that.

Mr. MCHENRY. Okay. So you get an IPO. Immediately, because of fragmentation, the market fragmentation, liquidity fragmentation, you have a substantial amount of your order flow off your exchange, right? Am I correct?

Mr. MECANE. Yes.

Mr. NOLL. Yes.

Mr. MCHENRY. Okay. So what you do to incentivize liquidity instantly benefits these folks. It doesn't benefit you. It benefits this order flow off your exchanges; is that correct?

Mr. MECANE. Yes.

Mr. MCHENRY. So this is part of the challenge, is what that incentive is for you, actually benefits not your companies.

Mr. MECANE. Yes.

Mr. MCHENRY. To be clear, I mean you have both accessed the public markets in a very unique way as an exchange, so you do have to be concerned about your revenue. So as a policymaker I look at this and am trying to figure out how to incentivize you. But instantly, how much of the order flow after an IPO goes off your exchange? Mr. Mecane?

Mr. MECANE. It is roughly—in a given name we will have roughly 30 percent of the market share across our different venues, 30–35 percent of the market share on our exchange, and then the rest will be fragmented across other exchanges and non-exchange venues.

To your point, a lot of the focus, and clearly we are self-interested in that argument also, but a lot of the focus is in—it is twofold. One is attracting as much liquidity to our market as possible; and, second, it is creating as much liquidity in general from that name. Clearly that benefits us from a revenue standpoint, but I think the more important point is to really take a particular company or their stock to the next level, it needs to be a name that institutional investors and long-term investors are comfortable investing in. And unless there is enough liquidity available, they are not going to be comfortable putting their funds into that particular company.

Mr. McHENRY. Mr. Noll? And then I will pass off to Mr. Quigley. I have gone over my time.

Mr. NOLL. Thank you, Chairman.

So I think the competition between marketplaces has actually been very healthy. It has been very healthy for us as an institution. I think it has been healthy in many ways for the marketplace. And I agree with Mr. Mecane that when we take a company public, we retain post-IPO about 30–35 percent of the volume in that name on an ongoing basis.

But the competition between markets has actually helped us to innovate. In many ways it created the success of NASDAQ over the long term. And so as we go forward and we start to think about what we need to do for small cap companies, it is not the competition with other venues that I worry about, it is the ultimate market structure that we put in place that will enhance the development of getting those companies to be public.

I think the competition between venues is a very healthy one. It inspires us to do better. It inspires us to work harder. And I think for us to compete for volume and for us to compete for success in this marketplace is not a bad thing. I think that is going to spur us to do a better job of it going forward, and we would fully expect to win more than our fair share of that business back in that kind of competitive environment.

So I am less worried about that kind of functionality than I am in the overarching market structure that would enhance small companies being able to go public.

Mr. McHENRY. Thank you.

Mr. Quigley.

Mr. QUIGLEY. Thank you, Mr. Chairman. So we want to help. We recognize that this is about striking a balance, to protect investors and the public and creating jobs.

Mr. Noll, you started off on a bit of a pessimistic note, which I appreciate and respect. But give me a little glimmer here. I am reading quotes from Renaissance Capital about 2010 being not so bad, that it was the first year since 2007 where the number of IPOs was back in the triple digit range. Obviously, it is not just the number that matters, but their performance. But they also quote and say IPOs didn't have just a good year in terms of numbers; their performance was strong, too. The average U.S. IPO rose 25 percent, the best returns for IPOs since 2006.

Do you agree with those numbers, see a trend or some hope along the future?

Mr. NOLL. Well, I think clearly there has been a lot of successes in this past year. On NASDAQ, of course, we look at Groupon and Zillow that have recently listed on our marketplace and done very well for investors, and in many ways those are both household names that many investors are very familiar with. So we have seen some repair in the IPO market from the depths of the financial crisis in 2008 and 2009.

I think what concerns us less is whether the household names go public, right, who have grown, they are big, they have significant revenues, they have a share of mind in the investing public because of their success off exchange. What concerns us much more than that is we are not seeing support either for going public or to, in the after-market for small companies who may not be as big as Groupon or may not be as big as Zillow, to go public. So small biotech companies, small green-energy companies who need to access capital and are struggling to find ways to do so.

So while there has certainly been a very positive change from the depths of the financial crisis to today in terms of IPOs, I still think that there are issues around those smallest capital companies and their ability to access capital.

Mr. QUIGLEY. Mr. Mecane?

Mr. MECANE. I would echo that comment. There has been a fairly robust IPO market in 2011. We have had a number of very large companies go public with us this year, Kinder Morgan, Linked-In, Pandora. The issue, as Mr. Noll said, is we are seeing much of that IPO activity concentrated with the large-cap stocks and not with some of the small- and mid-cap stocks that we have seen historically.

Mr. QUIGLEY. You alluded earlier to rules and concerns and issues. I look forward to the continued discussion. The devil is in the details. So on an ongoing basis we would encourage and appreciate your participation. Thank you.

I yield back.

Mr. MCHENRY. The vice chair, Mr. Guinta, for 5 minutes.

Mr. GUINTA. Thank you, Mr. Chairman.

Mr. Noll, I want to touch a little bit on what the chairman was talking about and relate it to market structure. I guess I wonder, there is obviously competition between the New York Stock Exchange and NASDAQ. But I guess I would start to ask the question this way: Who do you really see as your competition? I mean, I have great concern about market structure, I have great concern about the willingness of an IPO to occur on an exchange here in America. And I see a lot of these either M&As or listing overseas, I see that as a fundamental long-term problem economically, not just for job creation but for the potential and future investor.

So we are talking about the benefits that one exchange would have over the other, but I worry that we are focusing too much on you—not you, but NASDAQ focusing too much on the New York exchange or the New York Stock Exchange focusing on NASDAQ and the benefits that one would get from services provided by the other, when I think the longer term and the larger problem is a different competitor.

So how do you see it? Do you see the person sitting next to you as the competitor or do you see some other exchange as the real competitor?

Mr. NOLL. Clearly, Mr. Mecane and I are colleagues and respect one another's ability tremendously. And, yes, the New York Stock Exchange is a competitor of ours. But I think in fairness to where we really view competition is not just the New York Stock Exchange. In many ways it is a global competition, so we compete with other marketplaces, other venues around the world.

We also compete domestically, not necessarily against the New York Stock Exchange, but alternatives for capital raising. And what I mean by that is when a company is looking to raise capital or grow its business, who are we competing with for that capital raise? Oftentimes it is with a private equity firm or some other alternative for raising capital.

So, yes, there is a vigorous competition for listings between the New York Stock Exchange and NASDAQ in the United States on a daily basis, but our competition is much broader than that on the listing side.

On the trading side, it is even more robust than that. So clearly the New York Stock Exchange is one of our key competitors on providing a transaction platform, but we compete with transaction platforms among 13 other exchanges in the United States and 40-plus other trading venues, plus broker-dealers, plus foreign trading there. So we view our competition on the trading side in a much more robust way as well. And essentially what we are hoping to do in responding to that competition is with innovation, things like the BX Venture Market and other things that we have done that will help us gain trading volume and share by doing a better job. So our competition is very broad competition, not a very specific one.

Mr. GUINTA. So how much are you concerned about the services that you provide benefiting a competitor?

Mr. NOLL. I am much less concerned about the services we provide benefiting the New York Stock Exchange or, quite frankly, any of our other exchanges. I view that as state of being. We have a competitive environment out there and we have to respond to it by being better at our jobs.

I do think, though, that one of the critical things that we are going to have to think about in terms of going forward is how do we provide liquidity, whether it is on NASDAQ, whether it in the marketplace as a whole for these small-cap companies. So ultimately the market structure that has to be put into place is one that identifies that, not necessarily benefiting one market over another market.

Mr. GUINTA. What about off-exchange equity trading venues?

Mr. NOLL. They exist. They provide value in many ways. So I think it is important that off-exchange trading venues continue to exist where they can do things that we can't do or they do things for customers that we have been unable do. One of those is provide price improvement. One of those is to retain the ability to not have a large institutional order exposed to the marketplace; in other words, solve the information leakage problem. And, ultimately, if they are contributing to price discovery, you know, we have less issues with those things.

I think where we do have issues is when we as an exchange are barred or otherwise restricted in our ability to compete in that marketplace because of SEC rules or other strictures that allow us or prevent us from competing effectively and where those off-exchange venues are not contributing to a fair transparent market and to price discovery.

Mr. GUINTA. So liquidity is dispersed, you say, over 13 different exchanges. Are you suggesting that that is part of the liquidity problem?

Mr. NOLL. No, it is a fact. What I am noting is in those large-cap names, liquidity is scattered across 13 venues and 40-plus more off-exchange. Those venues aren't trading small-cap stocks though. All of that liquidity, all of that trading is taking place in what are essentially 100 very large names.

Mr. GUINTA. Okay. So if we want to grow the IPO market, should we be focusing on a small-cap——

Mr. NOLL. I think large companies to a large extent take care of themselves. Where we need help is in that small- and mid-cap sector, and I think that is where we should focus on our market structure rules, is how do we help those companies get liquidity, get research analyst coverage and access the public markets.

Mr. GUINTA. That is where I think we ought to be focusing as well. So through either a further line of questioning or additional future testimony, I would be very interested to know what you feel the two or three or four things that we can be doing to enhance that and augment that are. Because I think that is the direct nexus to job creation, whether it is in my home State of New Hampshire or anywhere in the country, but that is going to greatly benefit the local economy and I think the national economy.

Thank you, again, Mr. Chairman, for allowing me to extend my remarks.

Mr. MCHENRY. I certainly appreciate it. With the panel's indulgence, I would like to go for another round, if that is all right.

To be honest with you, at this point I started with the broad concept, why do the public markets matter, right? I mean, to the point where most—your hardworking American looks at the public markets and thinks it doesn't have relevance to them. But it does, because it brings in capital to the United States, lowers the cost of capital in a competitive marketplace, makes capital more available and cheaper. That is sort of the ideal here.

It also means that as opposed to private equity, that the hardworking American can put their money, whether it is $500 or $5,000 or $5 million, into the public markets and actually have proper price discovery and at the same time, hopefully, over a period of decades, get a nice return. But we are also talking about this challenge with small cap companies.

So one of the challenges is liquidity. So to discuss this, we begin with liquidity. What can you do as an exchange legally now to provide these small cap companies a measure of liquidity? Mr. Mecane?

Mr. MECANE. Sure. The primary mechanism that we as an exchange can use to incentivize liquidity is we have various market maker programs on our exchange where we incentivize those liquidity providers to meet certain liquidity and quoting obligations. In exchange for that, we share a portion of the economics that we obtained through our transaction services.

We have actually skewed some of those payments to the point where in some of the small cap names we are actually sharing almost more, or all or more of the revenue that we are able to get in the transaction part of the business just to try and incentivize further liquidity creation.

Mr. MCHENRY. The transaction part of the business, meaning the IPO, or is that the——

Mr. MECANE. Meaning the trading piece. So we're able to use some of the revenue that we generate from the trading part of the business, and we use that to subsidize the market making community.

One of the circular issues is that there's, in some of these names, not—we're paying out all the revenue that we generate and it's not necessarily enough to help get the liquidity to where we would like it to be.

Mr. MCHENRY. Uh-huh.

Mr. MECANE. That's part of the reason for why we think the experiment of also letting issuers compensate market makers could help, because in some circumstances, we're already paying all the revenue we have because most of that is on a per-transaction basis and these issues don't trade very frequently. It doesn't generate enough revenue to necessarily incentivize the liquidity providers.

Mr. MCHENRY. Okay, so the company goes through the whole process of going to the public markets. When they go to the public markets oftentimes what their broker dealer will say, well, we want to have price support for the first month or 6 months or year, whatever that may be, right? So the broker dealer provides price support.

Mr. MECANE. Correct. That's generally very specific around the IPO time when there is Reg M exemptions and permitted activities that broker-dealers can use too. But there isn't necessarily an economic relationship going forward after that specific IPO event.

Mr. MCHENRY. Okay, sure. The reason why I bring that up is structurally there is a level of support that currently exists in the marketplace legally.

Mr. MECANE. Correct.

Mr. MCHENRY. So what are the possible solutions? Let's just talk about some of the solutions?

Mr. MECANE. On the liquidity side, again, there's the idea of creating a different spread environment for small- and mid-cap stocks. It's hard to know in a perfect world whether that would actually work or not, that's why we've advocated perhaps a controlled experiment. But one of the dynamics of a penny spread environment, which, again, has been very beneficial in the large-cap stocks, is that when you have stocks that will trade with a wider spread of a nickel or a dime, something along those lines, but there's the ability for another market participant to come into the marketplace and better whatever prices are there by just a penny, so not significantly narrowing the spread, but just narrowing it by a small increment.

We think that by actually holding wider spreads in discrete intervals of a nickel or a dime, it could actually incentivize people to put more liquidity into the market because they will be more confident that someone won't step in front of their bid or their offer with a de minimis amount. Again, it wouldn't be the only fix to the issue that we're talking about. I think anything we do has to be part of a comprehensive package.

Mr. MCHENRY. So that actually—on its face, that increase is then efficiency.

Mr. MECANE. That's why it is very counterintuitive. In a way, we think it could actually improve efficiency. And that's why we are not saying it should be nickels or dimes with the very liquid stocks where a penny works very well. If the natural spread for a stock is a penny, then it makes sense that the stock should trade at a penny. What we are more targeting is where the natural spread for a stock looks like it's more in the $0.05 or $0.10 range, but you're still allowing very small increments to be quoted in the marketplace and whether that's actually efficient, even though it appears inefficient.

Mr. MCHENRY. So is that spread differential based purely on volume?

Mr. MECANE. I think there are a number of factors, and it would be need to be debated by the industry and the SEC what the right framework would be. But I think it would be some combination of volume, market cap, perhaps the price of the stock. I think there are a number of factors that would go into determining the right intervals.

Mr. MCHENRY. And so could you create—I mean, conceptually, could you create a system by which the competition would determine what that spread is? So as the volume goes up and the market cap goes up, the spread could tighten?

Mr. MECANE. Correct. And I think it would need to be a collaborative industry solution. Part of why we haven't done something like this on our own and why we can't on our own is because if we're the only ones quoting in different increments but everyone else is quoting in penny increments, it just doesn't work. It needs to be an industrywide solution. When the SEC put their concept release out in early 2010, this was one of the items that they raised. We, in our comment letter, indicated that this would be a good market-wide experiment to help the trading and small- to mid-cap stocks, but it would be an industry wide solution.

Mr. MCHENRY. Mr. Noll, would you like to touch on some of these areas?

Mr. NOLL. Sure. You know, I think I go back to an earlier statement I made, which is what's critical here is that market makers have to be incented in the right way to provide liquidity. So they will not do so at the risk of their own capital where it's not economically viable for them. What's important is to create that viable platform for us to be able to incent market makers. Some of that may be tick sizes in making the spread more viable for them to provide liquidity there. Some of it may come from liquidity payments directly from issuers or through exchanges. And some, quite frankly, is what I would call a time and place advantage, which is under our current market construct, you know, every market maker starts out evenly, and it's best price that wins and oftentimes the first at that best price of what we call price time allocation system.

So for smaller cap stocks what might be more important is creating a time and place advantage for market makers rewarding them by providing liquidity at that—in those small-cap companies. So by ensuring that they get a larger piece of the trade, not necessarily because they were there first. So within that mix of ideas, I think there are many things that exchanges can do to provide liquidity in these small-cap companies.

Mr. MCHENRY. So you both mention the benefits—well, you mention the positive nature of market fragmentation. What if you took these small-cap companies and there was—and you were only to market, there was no market fragmentation, walk me through that.

Mr. NOLL. Well, if there was no market allocation——

Mr. MCHENRY. Is that objectionable to you or positive to you or——

Mr. NOLL. I think the critical thing would—to make sure that that would not be permanent. I think there is a certain benefit for what I would call a runway period of time. So if you had a small-cap listing on your venue and you had a runway to establish liquidity, incent market makers to create that liquidity and build a marketplace there, I think that could have some very positive effects.

I think where it starts to become dangerous is if that looks like it could be a permanent state of being. And so where I think we would want to see the market go is if that was a market structure and a mission it was developed to help concentrate liquidity and IPOs and small-cap companies, we would want to make some very clearly delineated lines around that whereby other advantages could start to compete for that business as well, because ultimately, I think that competition is necessary.

So if you want to give companies runways, I think that's an interesting idea and one that we'd be certainly willing to explore, but I'd want to see an end date for that.

Mr. MCHENRY. Mr. Mecane, do you want to touch on that? I'm not trying to create a bunch of controversy, but we're throwing out concepts to—on this problem and——

Mr. MECANE. It is a very good question, and it's one that does get a significant amount of debate in the industry, obviously given that there isn't a clear-cut solution. There is obviously a balancing act between concentrated liquidity and the whole liquidity begets liquidity argument, about, you know, having as much robust price discovery, having it in one place versus the benefits of competition, and having diverse competing venues also trying to generate liquidity and market share, etc. And the question is, where's the tipping point between the healthy level of fragmentation and, you know, when, if any, does it go too far?

One of the factors that we highlighted is that while there's an average level of activity that happens away from the primary market or away from exchanges, it tends to be much, much higher in the small and mid-cap stocks. There's a lot of reasons for that, it is not necessarily clear, but one reason is because the spreads are wider, so there's an increased incentive to trade those names proprietarily if firms can. Some of it is because a lot of those names tend to have a higher proportion of retail investors in them, so they tend to get traded away from the exchanges.

One of the things that we've done, as I mentioned, is we've launched a program recently which isn't in effect yet but it's out for comment, to try and attract retail orders specifically to exchanges where we think in mid- and small-cap stocks, it will be beneficial.

Again, the theory there being that perhaps if we concentrate more liquidity together, especially in those small- and mid-cap names, perhaps there could be a feedback loop in terms of also generating additional liquidity. It is unclear what the result will be, but again, we are just trying different things to get at the problem.

Mr. McHENRY. Sir, you mentioned in your opening remarks the ability to purchase liquidity support. Explain to us how that functions?

Mr. MECANE. Sure. So right now in many European markets, including the ones we operate, private companies have the ability to contract with brokers to offer a certain amount of liquidity support for their stocks. In general, the academic research has shown that it is beneficial, and it helps improve the spread in liquidity in the name. The one distinction is that those programs do exist in a very different market structure where—than the one we exist in, especially the periods of time that have been studied in those academic studies tended to focus on more monopolistic-type environments and——

Mr. McHENRY. Less fragmented.

Mr. MECANE. Less fragmented. And so the only point I'm raising is that I am hesitant to draw a direct analogy, but think it's worth an experiment.

Mr. McHENRY. Worth——

Mr. MECANE. Trying.

Mr. McHENRY. Seeing if it works.

Mr. MECANE. Right.

Mr. McHENRY. Thank you for your indulgence. And I now recognize the vice chair, Mr. Guinta.

Mr. GUINTA. Thank you, Mr. Chairman. I want to go back a little bit to the competitive issue, and how ultimately we ought to be providing flexibility and options for small-cap companies. I guess I should be a little more specific in my line of questioning.

The first question I would have is the services that you provide—I will ask Mr. Mecane first, the services that you provide, would you say that they help a competitor once a company's listed?

Mr. MECANE. I do think there is a certain level of that because of the nature of our industry where it is a very competitive market, and anything that we create can be generally replicated or copied by other venues. I don't think it is necessarily a bad thing in that the—there is a benefit to first mover advantage, but clearly, it could be—you know, there's a certain negative result when everyone else ends up doing the same thing.

Where I do think, though—but generally, the competition that we're talking about, whether it is price competition or new product competition, even though it might not be as beneficial for us as venues, ultimately the consumer benefits from that. It generally will result in more product choice, or it will result in lower prices. Where I do think that competition becomes unhealthy or a problem is where it becomes regulatory competition to use a different phrase. One of the things that we advocated for is that all participants in the marketplace were performing similar functions should be subject to similar regulation. I think that also fits into surveillance and oversight theme. One of the initiatives that the SEC has advocated is this creation of a consolidated audit trail, and what that will do is aggregate together all the activity in the marketplace and give a consolidated view of all the trading and all the activity that's happening, not just on exchanges, but on other venues. And I think that type of consolidation is very important, especially as it relates to people's confidence in the public markets.

Mr. GUINTA. What about the idea, or the notion of a new issuer paying for their own services or designating some of their funds for that—for that specific service. I know earlier you said that you utilize the revenue that you gained for that to provide that service, but you also—I don't know if you said it, but I will assume it that you don't have enough revenue. Therefore, should we be exploring the opportunity of allowing a new issuer?

Mr. MECANE. Yes. To link all those things together, everything you said is correct. We do share the revenue that we generate in incentivizing liquidity providers. One of the challenges with small and mid cap stocks is that in a lot of cases, we're paying everything that we make. And so supplementing that with a direct payment from the issuer is, we think, a worthwhile experiment. Clearly, there's issues that need to be tackled.

Mr. GUINTA. Sure.

Mr. MECANE. One of the things I said earlier is there is a conflict inherent in that relationship. And one of the things that we've explored and been pushing is that the ETF market, where you don't have that same conflict, but you still have some of the liquidity concerns with newly created products could be an area to conduct an experiment and see whether you get beneficial liquidity in some of the less liquid ETFs as a result of this type of program. And then assuming we can document positive results, we can then try a second experiment with some stocks and see if it has the same effect.

Mr. GUINTA. There are a number of ways we could meet that objective that ensure the conflict of interest is mitigated.

Mr. MECANE. Correct.

Mr. GUINTA. Talk to me a little bit about, you mention the regulatory concerns. What are some of the regulatory issues that we should try to address?

Mr. MECANE. One just general topic that has been discussed, and is a frequent topic of the SEC's agenda and one of the things that they are working on is around the level of disclosure for different activities and filings that have to be made. Clearly exchanges have a very high level of public disclosure about our activities and how we handle orders and our pricing. And one of the topics is whether that level of disclosure should be applicable to all market participants. And there is valid reasons on both sides of the argument, but clearly from our standpoint, we think that a similar level of disclosure is warranted.

Mr. GUINTA. Okay. Thank you, Mr. Chairman.

Mr. MCHENRY. Thank you. Thank you, the discussions about the consequences or potential negative consequences of this liquidity support. So walk me through this, if liquidity support agreement required these following couple of things, four things, the agreement is publicly disclosed, the liquidity provider does not provide hedging service to third parties, the liquidity provider does not trade on a proprietary basis of the issuer's security, and the liquidity provider does not reveal its trading strategy or the plan transactions to the issuer. Do you think that would be sufficient to counter the possible negative consequences?

Mr. MECANE. I think that's definitely a good place to start.

Mr. MCHENRY. Are there additional things you would require?

Mr. MECANE. There could be a public disclosure of the terms of the arrangement. We could, through the exchange or SEC, there could be a mechanism to, you know, disclose exactly what's being done. There might be confidentiality concerns around that. So we could debate at what level, but I think perhaps some additional public disclosure of certain terms could be helpful.

Mr. MCHENRY. And duration.

Mr. MECANE. What the obligations are, what the payment structure is.

Mr. MCHENRY. Okay. Mr. Noll.

Mr. NOLL. I agree with Mr. Mecane, those are very good places to start. A couple areas perhaps to pay a little more attention to, when you talk about proprietary trading, clearly as a market maker, the market maker is going to be taking positions in the security, that's one of the things that providing liquidity means——

Mr. MCHENRY. Yes.

Mr. NOLL [continuing]. So delineating what is a market maker position and what is market maker behavior from what is a speculative proprietary position.

Mr. MCHENRY. That can't be too complicated, how many pages is the simple Volcker rule? It adds what, 300 pages?

Mr. NOLL. I think you could burn a lot of brain cells trying to find that line. Those are the areas that I think we would have to spend some attention on.

One possible area to look at, I think as an addition is what is the definition of market called that you're looking for, and having that be a transparent part of this proposal which is, this is our expectation as a company for what we expect to see, from supporting this kind of market maker support system, spreads of X percent and depth of Y securities. As part of that overall process, I think maybe a healthy area as well.

Mr. MCHENRY. Okay, okay, interesting. This has been very helpful. I know we've touched on a number of things here, you know, global competition is certainly a concern, obviously you both touched on that to some degree, and the importance of really bringing capital to the United States. I mean, that's really what our capital markets are about, it is sort of being a sponge to bring in capital. Are there any things you want to add additionally, just in this broad concept we're talking about? Ideas, solutions problems we haven't touched on in this hearing? Mr. Noll.

Mr. NOLL. We have touched on almost everything, but I do want to emphasize I think the problem here is not just about liquidity and not just about market structure. There is clearly regulatory impediments for companies going public. You could group them most largely in what I will call Sarbanes-Oxley, but there are more than those. I think addressing those I think is also going to be critical to making the success if we are going to improve the IPO market for small——

Mr. MCHENRY. Do you want to talk about anything in particular with Sarbanes-Oxley?

Mr. NOLL. Well, clearly the 404 restrictions and allowing that market to have companies that are exempt from that to be higher than it is today.

Mr. MCHENRY. Uh-huh.

Mr. NOLL. We agree with the billion dollar mark that we've seen out there. And we think that that's something that would be very useful for companies as they go forward. You know, implementing perhaps a time or a grace period for companies after they go public may also be very beneficial.

And then we are very concerned about the new PCAOB requirement that companies change auditors as we go forward, because it feels to us, in many ways, like an unnecessary expense. One of the benefits of working with an auditor over time is that they know the company and they become very familiar with the way the company works. And so the cost of the audit actually goes down. To hit the switch, auditors on a frequent basis to bring new auditors in creates a very expensive proposition for companies, and yet another reason why a company may not want to go public. So I think it's important that we think about those in this context as well.

Mr. MCHENRY. Mr. Mecane.

Mr. MECANE. I will echo what Mr. Noll said and the point I made earlier which is that any type of reform that we do needs to be part of a broader package, I don't think any market structure fixes, in and of themselves, are going to necessarily fix the problem. I point again to the IPO task force report which I thought did a very good job of coming up with very discrete, concrete recommendations that are reasonably implementable as a path forward for increasing potentially research coverage, making it easier for companies to go public, and perhaps palatable, regulatory relief that could help loosen up some of the trends that we've been seeing.

Mr. MCHENRY. What about securities class action lawsuit reform?

Mr. MECANE. As a non lawyer——

Mr. MCHENRY. I like the stare off here.

Mr. MECANE. It is something we can certainly get back to you on.

Mr. MCHENRY. That is a creative answer. Let me ask this in a different way, because that wasn't even—it was an open-ended statement really. Do security class action lawsuits and the structure and form and the payment and expense, do they disincentivize the public markets?

Mr. MECANE. What I would say very broadly is that I believe that when companies are evaluating their different future options that there's a perception of a cost of being public, some of that being the oversight of quarterly earnings, and complying with the different rules. Some of it is, to your point, chairman, subjecting yourself to potential lawsuits from investors, etc. I think that goes into the evaluation and the equation whether conscious or subconscious about whether people's best path forward is a public or a private one. I think anything that potentially increases the cost of going public is negative.

Mr. MCHENRY. Mr. Noll.

Mr. NOLL. I would agree with Mr. Mecane there. We would have to also get back to you with our opinion about securities litigation reform. I do want to emphasize that one of critical things that exchange markets do do by being transparent markets is create a set of rules by which all companies have to abide by, both in their listing standards and in the trading of those rules. And so keeping investor protection in the front of our minds is also important. So to the extent that anything that supports investor protection in this process is something that we wouldn't want to give up as we go forward.

Mr. McHenry. Okay, well on that area of agreement you'll both get back to us. I certainly appreciate your willingness to have the conversation here this morning. This is the roadblocks to public markets and the impact that has on job creation. I mean, this is not something we touched on, but obviously, when companies are able to go to the public markets, access capital, they are able to greatly expand their work force and what their able to do in terms of offering a product or their service.

And so having a vibrant public market goes right along with vibrant labor markets and modern societies around the world historically, but I appreciate your willingness to have the conversation about these ideas, about these concerns, potential solutions, but also the current struggles that we're facing right now.

I appreciate your ability to have that conversation and sort of engage in a broader range of subject matters this morning. We very much appreciate it. And as policymakers here, those watching from their offices and those of us that are trying to craft legislation to free up capital formation in this country, this is very helpful. Thank you for your time. With that, you'll have—you'll each have—I've got my final script here, you'll have 7 days to add additional comments to the record, as do Members. With that, this meeting stands adjourned. Thank you.

[Whereupon, at 11:18 a.m., the subcommittee was adjourned.]

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