

Testimony of  
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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.<sup>1</sup> 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

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<sup>1</sup> <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<sup>2</sup>, 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<sup>3</sup>, 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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<sup>2</sup> Venture Impact Study 2010 by IHS Global Insight.

[http://www.nvca.org/index.php?option=com\\_content&view=article&id=255&Itemid=103](http://www.nvca.org/index.php?option=com_content&view=article&id=255&Itemid=103).

<sup>3</sup> 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<sup>4</sup>, 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<sup>5</sup>. 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<sup>6</sup>, the Commission could consider stronger market maker obligations such as best price obligations, depth

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<sup>4</sup> Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth, page 26. [www.nvca.org](http://www.nvca.org).

<sup>5</sup> NYSE Euronext internal data analysis.

<sup>6</sup> 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.<sup>7</sup>

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 7<sup>th</sup> 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](http://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.

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