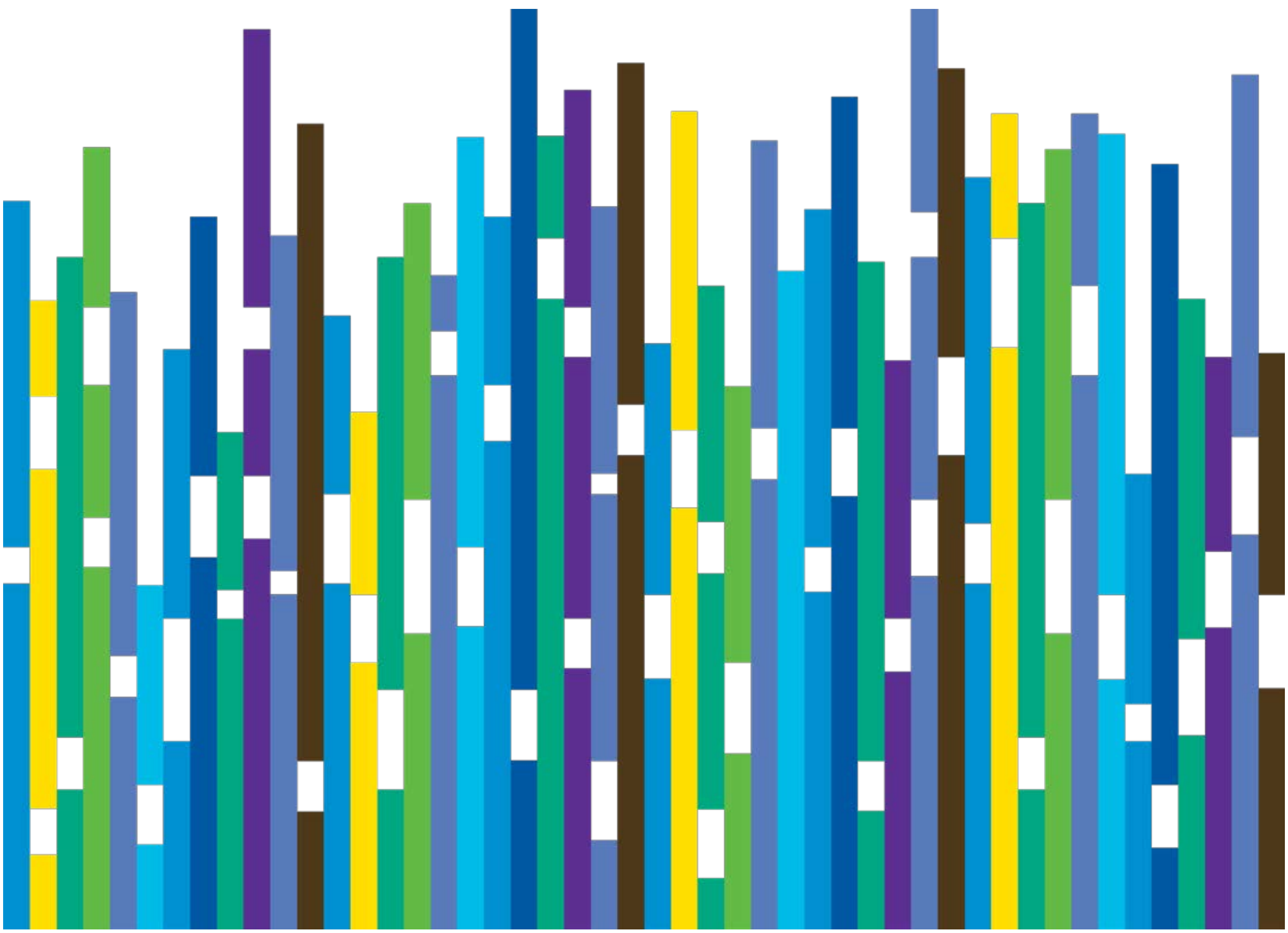
CFA Institute

POLICY BRIEF

UNITED STATES VENTURE MARKET

Has the Time Come?



UNITED STATES VENTURE MARKET

Has the Time Come?

In recent years, slow economic growth, reduced bank lending to small companies, and fewer initial public offerings have prompted policymakers to seek ways to direct capital to small and startup companies through rule exemptions. But investors worry about the binary regulatory structure created by rule exemptions because of the higher investment risks posed by companies taking advantage of these exemptions. These competing views coalesce into an interest in a venture exchange structure in the United States to list smaller and startup companies operating under relaxed listing and regulatory rules. To consider how to make such an exchange system viable, CFA Institute assembled an expert panel to discuss the issue.

Policy Developments

To overcome reduced bank lending to small and startup companies, regulators have implemented policies that allow for a lighter regulatory touch on those companies to encourage them to raise capital in the public markets. The approach has evolved into a growing interest in creating a venture exchange structure in the United States on which venture companies operating under a set of rules and regulations that are less costly and onerous than current NYSE or NASDAQ rules, but still robust enough to offer adequate investor protections, will be listed.

The success of a venture market would depend on a balance of issuers' desire for lighter regulatory burdens to reduce their costs with investors' desire for rules that ensure adequate governance standards and regulatory requirements that ensure the timely dissemination of relevant and reliable information. Venture market operators' views would be aligned closely with those of their listed companies, but they would want greater flexibility on matters relating to trading and competition. Broker/dealers would require rules that allow them to make retail investors aware of and encourage investment in venture companies without incurring potential legal risks. And regulators would need to meet their mandate of protecting investors from fraudulent issuers.

Such markets already exist outside of the United States, which provides a template for US policymakers on what to do and what not to do when creating a venture market structure in the United States. London's AIM market, for example, relies heavily on investment bankers and broker/dealers called nominated advisers, or nomads, to vet venture companies and walk them through the initial offering process. This approach imposes lower reporting requirements on listed issuers than does Toronto's TSX Venture Exchange (TSXV), which uses a more centralized and exchange-based due diligence process.

OTC Markets Group's OTCQX and OTCQB markets in the United States are currently the closest approximation the country has to public venture capital markets, with more than 1,300 companies. They use sponsors to vet issuers and enforce listing-like standards for companies. Investors can buy and sell OTC securities much as they trade securities listed on the New York Stock Exchange (NYSE) or NASDAQ.

Exchange vs. Alternative Trading System

Companies that are on the OTCQX and OTCQB markets are quoted on an alternative trading system (ATS), not a dedicated exchange. This system relies on a negotiated dealer market in which buyers and sellers know their counterparties and each can see the depth of the trading book. In comparison, an exchange would function as a self-regulatory organization (SRO) that would set regulations for companies that list and for market participants that trade on its markets. Exchanges also must adhere to a full set of regulations not applicable to ATSs. One consideration for lawmakers when designing a venture market is whether a market needs to operate with a dedicated physical exchange or whether an ATS system would be preferable.

The following is a summary of some of the issues that policymakers must consider for such markets to work:

- A robust vetting process to weed out bad actors in management, on the board, and in the principal investor ranks of potential venture companies
- A sponsor system in which broker/dealers, a similar group, or the exchange undertakes initial due diligence on venture companies
- Annual audits, with the auditor's report included in an annual report to shareowners
- Quarterly updates on performance and financial condition
- Use of generally accepted accounting principles in the preparation of financial statements
- Timely disclosure of all important company news through normal public distribution channels
- Company principals liable for fraudulent representations made in offering documents, financial statements, or company announcements delivered through these channels
- High standards of transparency and governance, deviating from best practice standards only for legitimate reasons unique to small companies

Viewpoint of CFA Institute

The interest of CFA Institute in a specialized marketplace for small and startup companies grew out of concern about the reduced regulatory requirements granted to such companies in the Jumpstart our Business Startups Act (JOBS Act) of 2012. By granting exemptions to internal audit controls and other governance and reporting rules, the JOBS Act created a separate regulatory system for these companies without giving investors an easy way to recognize who was taking advantage of these exemptions. We had considered other alternatives, from a stamp on SEC filings and other notifications, but were told by our member volunteers who practice investment management that such fixes were insufficient. They suggested a separate exchange.

CFA Institute supports a venture exchange rather than an ATS for these companies. The reason is that investors need to be aware that the companies taking advantage of the exemptions pose a higher level of risk than other publicly traded companies, in part because of reduced regulatory requirements. Moreover, we believe that all the shares of companies listed on the exchange should trade on that exchange to ensure that investors are not investing blindly in these companies.

We also believe that rules relating to the creation of such an exchange should allow for regulatory flexibility in terms of trading structures and rules, which would permit the exchanges to experiment with new systems and structures that they believe are needed to address trading anomalies. Finally, we believe the SEC should have the authority, but not a requirement, to grant charters to more than one venture exchange to ensure that trading costs and listing fees are transparent and competitive.