Testimony on "Venture Exchanges and Small-Cap Companies"

by

Stephen Luparello, Director
Division of Trading and Markets
U.S. Securities and Exchange Commission

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Chairman Crapo, Ranking Member Warner, and Members of the Subcommittee:

Thank you for inviting me to testify on behalf of the U.S. Securities and Exchange Commission ("SEC" or "Commission") regarding exchanges focused on the listing and trading of stocks of smaller companies. Smaller companies are important to the strength of our economy. The SEC welcomes the opportunity to discuss approaches that address the market structure needs of smaller companies and their investors, which can serve to facilitate capital formation for such companies – an important part of the agency's mission.

The SEC is considering innovative approaches that appropriately balance the needs of smaller companies for efficient secondary markets and the interests of investors in smaller companies. Venture exchanges potentially could achieve such a balance by providing the investors a transparent and well-regulated environment for trading the stocks of smaller companies that offers both enhanced liquidity and strong investor protections. As such, they could strengthen capital formation and secondary market liquidity for smaller companies and expand the ability of all investors to participate through well-regulated platforms in the potential growth opportunities offered by such companies.

Venture exchange listings could include both smaller companies that do not qualify under the listing standards of the large securities exchanges and smaller companies that do qualify under such standards. [1]

My testimony today will provide an overview of market structure challenges for smaller companies, efforts that the SEC already has taken and is taking in this area, and statutory provisions that set the context for SEC review of venture exchange proposals. It is important to consider, as part of our review of current market structure, the distinctive needs of smaller companies and their investors.

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[1] Venture exchanges potentially could include existing or new exchanges that operate nationally. The Commission could also consider local or regional exchanges that focus on companies from a particular geographic area.

I. Market Structure Differences for Smaller Companies

The market for small companies is different from the market for large companies. While smaller companies contribute significantly to the U.S. economy, the opportunities for smaller companies seeking capital and for investors seeking to invest in smaller companies are not comparable to such opportunities with respect to larger companies.

For example, the smaller the company, the lower the level of ownership by institutional investors, which act as intermediaries for much of the available capital in the modern U.S. equity markets. Smaller companies face the challenge of attracting the attention of these institutional investors that typically seek to invest in large sizes that are significant given the size of their portfolios. Moreover, given that most smaller companies will inevitably have a significant percentage of ownership by individuals who are self-directed investors, small companies face the challenge of attracting the attention of these individual investors, who often do not have the time and resources of institutional investors to evaluate companies. To illustrate, Table 1 below sets forth ownership data for exchange-listed companies categorized by their market capitalization. As can be seen, institutional investors dominate ownership (83.5%) in Table 1's category of largest companies, which are defined as those with more than $1 billion in market capitalization. In contrast, for companies with less than $100 million in market capitalization, individuals dominate ownership with 80.1% of ownership or higher.

Table 1
Percentage Ownership of Exchange-Listed Companies[2]

Market Cap (millions)	Median Institutional Ownership	Median Individual Ownership
$0-50	10.9%	89.1%
$51-100	19.9%	80.1%
$101-250	31.3%	68.7%
$251-500	43.7%	56.3%
$501-1000	62.4%	37.6%
$1001+	83.5%	16.5%

[2] Jeffrey M. Solomon, CEO, Cowen and Company, "SEC's Advisory Committee on Small and Emerging Companies – Panel Discussion" at 13 (September 17, 2013) ("Solomon Presentation") (*citing* Bloomberg and CapitalIQ as of September 6, 2013 for listings on major U.S. exchanges), *available at* http://www.sec.gov/info/smallbus/acsec/acsec-091713-jeffreysolomon-slides.pdf). A recent academic working paper found that, between 1980 and 2010, institutional investors increased their holdings of the smallest companies that make up 10% of the value of the market from 3.5 percent to 10.2 percent. *See* Marshall E. Blume and Donald B. Keim, Working Paper, *Institutional Investors and Stock Market Liquidity: Trends and Relationships*, 1 (Aug. 21, 2012), *available at* http://finance.wharton.upenn.edu/~keim/research/ChangingInstitutionPreferences_21Aug2012.pdf. While the study uses market value percentages, and thus is not directly comparable to an analysis using percentages of the number of stocks, it provides evidence of a potential upward trend in institutional ownership of small-cap stocks.

These major ownership differences between small companies and large companies are reflected in their coverage by research analysts. Table 2 below sets forth data on the research coverage of NASDAQ-listed companies categorized by market capitalization. For Table 2's largest category of companies with more than $1 billion in market capitalization, only 1% have no coverage, and the median number of analysts is 14. For companies with less than $100 million in market capitalization, the median number of analysts is 1 or less, and 40% or more of companies have no research coverage.

Table 2
Research Coverage of NASDAQ-Listed Companies[3]

Market Cap (millions)	No Coverage	Median Analysts
$0-50	62%	0
$51-100	40%	1
$101-250	18%	3
$251-500	8%	4
$501-1000	3%	7
$1001+	1%	14

Tables 1 and 2 also illustrate that not all "small" companies are alike. Although all companies with less than $1 billion in market cap often are considered small-cap or micro-cap companies,[4] there are major differences in ownership and research coverage even within this category. They range from 62.4% institutional ownership and a median of 7 research analysts for NASDAQ-listed stocks with $501 million to $1 billion market cap, to 10.9% institutional ownership and a median of 0 analysts for NASDAQ-listed companies with less than $50 million market cap.

These differences among tiers of smaller companies are also replicated in various measures of secondary market liquidity. The Office of Analytics and Research in the Division of Trading and Markets posted a research paper in September 2014 that analyzed the market quality for small capitalization U.S. equities.[5] Among other things, the paper sets forth differences in volume, bid-ask spreads, and order book depth for exchange-listed companies with different market capitalizations and stock prices (see Table 3).

[3] Solomon Presentation, *citing* CapitalIQ as of September 6, 2013.

[4] For example, the S&P SmallCap 600 Index includes companies with market capitalizations that range from $400 million to $4 billion. *See* S&P Dow Jones Indices, *available at* http://us.spindices.com/indices/equity/sp-600. The Russell Microcap Index includes companies with market capitalizations that average $560 million and range as high as $3.47 billion. *See* Russell Investments, *available at* https://www.russell.com/indexes/americas/indexes/.

[5] Charles Collver, "A characterization of market quality for small capitalization US equities" (September 2014) ("Small Cap White Paper"), *available at* http://www.sec.gov/marketstructure/research/small_cap_liquidity.pdf.

Table 3 Market Quality Measures for Small and Medium Cap Exchange-Listed Stocks in 2013[6] Stock Price from $10 - 19.99				
Market Cap (millions)	**Ticker Symbols**	**Median Dollar Volume**	**Median Quoted Spread**	**Cumulative Order Book Depth (buy orders 10¢ from midpoint of best bid and offer)**
<$100	122	$11,000	28.61¢	$9,200
$100-249	148	$185,000	10.51¢	$27,900
$250-499	175	$761,000	4.78¢	$51,400
$500-999	143	$2,413,000	2.49¢	$146,100
$1000-1999	92	$5,828,000	1.40¢	$361,100
$2000-4999	60	$16,754,000	1.03¢	$898,400

This research illustrates that significant measures of market quality rapidly deteriorate as market capitalization decreases. Smaller companies generally will have less favorable metrics of market quality than larger companies. Among other things, smaller companies on average have less public float than larger companies, which yields less potential for trading volume.[7] Most market quality metrics are highly correlated with trading volume. The key issue for the Commission to consider is whether the current U.S. market structure optimally promotes capital formation for smaller companies and the interests of their investors, which necessarily requires an analysis of whether smaller companies can maximize their volume and other measures of liquidity and market quality.[8] The data in Tables 1-3 counsel an ongoing evaluation of how

[6] *See* Small Cap White Paper at 4, 7, 15, and 17.

[7] Some of the lower liquidity of small cap stocks also may be due to greater informational asymmetries, hence, higher information risk for small caps. *See* Easley, David, Soeren Hvidkjaer, and Maureen O'Hara, 2002, Is Information Risk a Determinant of Asset Returns? *Journal of Finance* 57(5), pp. 2185–2221.

[8] Low secondary market liquidity may be reflected in a higher cost of capital, which can potentially have adverse effects on capital formation. For example, research has shown that investors in less liquid stocks demand a return premium, which translates into a higher cost of capital for issuers, and hence may affect the allocation of resources in the economy. *See* Amihud, Yakov, 2002, Illiquidity and Stock Returns: Cross-Section and Time-Series Effects, *Journal of Financial Markets* 5(1), pp. 31-56. Amihud, Yakov, Haim Mendelson, and Lasse Pedersen, 2005, Liquidity and Asset Prices, *Foundations and Trends in Finance*, now Publishers Inc., Hanover, MA. Brennan, Michael, Sahn-Wook Huh, and Avanidhar Subrahmanyam, 2013, An Analysis of the Amihud Illiquidity Premium, *Review of Asset Pricing Studies* 3(1), pp. 133-176. The illiquidity premium is concentrated among small stocks. *See* Ben-Rephael, Azi, Ohad Kadan, and Avi Wohl, 2013, The Diminishing Liquidity Premium, *Journal of Financial and Quantitative Analysis* (forthcoming), *available at:* http://ssrn.com/abstract_id=1099829.

A recent study estimates the monthly illiquidity premium to be 0.5%. This study also finds that return anomalies are attenuated when liquidity increases and concludes that policies to stimulate liquidity and ameliorate trading costs improve capital market efficiency. *See* Chordia, Tarun, Avanidhar Subrahmanyam, and Qing Tong, 2014, Have Capital Market Anomalies Attenuated in the Recent Era of High Liquidity and Trading Activity? *Journal of Accounting and Economics* 58(1), pp. 41-58. Investment banks' fees in seasoned equity offerings (SEOs) are also significantly higher for firms with less liquid stock. *See* Butler, Alexander, Gustavo Grullon, and James P. Weston,

market structure can be changed to improve secondary market liquidity for smaller companies and their investors.

II. SEC Efforts to Improve Market Structure for Smaller Companies and Their Investors

A. SEC Advisory Committee on Small and Emerging Companies

The challenges facing smaller companies and their investors have been a focus at the SEC for some time. This focus has been highlighted in the SEC's Advisory Committee on Small and Emerging Companies ("Advisory Committee"). The Advisory Committee's mandate relates to small and emerging privately held businesses and publicly traded companies with less than $250 million in public market capitalization. Its mission is to provide the Commission advice with respect to protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation, as they relate to capital raising, trading, public reporting, and governance requirements in the securities of these small companies.

In March 2013, the Advisory Committee recommended to the Commission the creation of a separate U.S. equity market that would facilitate trading in the securities of small and emerging companies.[9] The supporting materials for that recommendation indicate that two of the most significant challenges facing such companies in the secondary market are attracting the attention of a wide range of investors and –closely related – achieving a liquid secondary market.

B. Prior Approval of Venture Exchange

Traditionally, exchanges have offered a suite of services that are tailored to meet the needs of two key constituencies of an equity market – listed companies and investors. For listed companies, exchanges can offer heightened visibility and a more liquid trading market than might be available in the unlisted markets. For investors, exchanges can offer important investor protections, such as heightened transparency of trading, and effective oversight of trading and listed company standards. These investor protections help promote confidence in the integrity of the trading market and listed companies. In addition, a good secondary market can support capital formation and issuers' ability to raise capital on more favorable terms. By offering greater liquidity and more efficient pricing, a good secondary market helps assure that investors will have an efficient means of liquidating their positions in a company if and when they choose. And a strong secondary market generates price discovery that helps efficiently allocate capital to the companies most able to put it to productive use.

In addressing the unique needs of smaller companies and their investors certain considerations need to be addressed. For example, smaller companies generally involve greater investment risk. For investor protection purposes, it is vital that investors understand those risks

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2005, Stock Market Liquidity and the Cost of Issuing Equity, *Journal of Financial and Quantitative Analysis* 40(2), pp. 331-348.

[9] The Advisory Committee's materials are available at http://www.sec.gov/info/smallbus/acsec-archives.shtml#recommendations.

and that the nature and size of their investment is suitable for their investment objectives. Exchanges, the SEC, and other regulators must be aware of the risks associated with smaller companies and put appropriate protections and surveillances in place to help minimize them.

The Commission also has previously approved market-driven proposals that appropriately balance the benefits and risks of smaller companies, while protecting investors. For example, the Commission approved a venture exchange in 2011 – the BX Venture Market created by NASDAQ OMX BX, Inc.[10] The BX Venture Market is designed for securities of smaller companies being delisted from another national securities exchange for failure to meet quantitative listing standards and for smaller companies contemplating an initial exchange listing. The goal of the BX Venture Market is to provide an opportunity for smaller businesses to have their securities traded in an environment that offers the potential for enhanced transparency, liquidity and regulatory oversight, which could make these companies more attractive to potential investors. The BX Venture Market's rules include a variety of measures to address investor protection concerns. These include rigorous vetting of listing applicants, such as background checks and independent investigators, enhanced surveillance of trading, and clear disclosure to investors that BX-listed securities differ from other exchange-listed securities because they generally present more risk, among other things.

In approving the exchange, the SEC noted that the exchange could provide small companies with an alternative to being quoted on the unlisted market by offering these companies the opportunity to list their securities on an exchange, in an environment that offers the potential of enhanced liquidity, transparency and oversight. Moreover, providing an alternative to the over-the-counter market could also facilitate competition for the quotation/listing of securities of smaller issuers. In addition, the SEC noted that the availability of an exchange listing, and the prospect of more efficient secondary market trading, could facilitate smaller issuers' ability to raise capital and invest in the growth of their businesses. Finally, the Commission believed that clear disclosures distinguishing BX Venture Market from the NASDAQ Stock Market would reduce the potential for investor confusion.

To date, however, the BX Venture Market has not been launched. My understanding is that concerns about ensuring adequate liquidity in BX-listed securities and attracting liquidity providers, at least in part, have caused the delay.

C. Tick Size Pilot

The Commission also has sought to address concerns about improving liquidity in the secondary market for smaller companies through the development of a pilot program that would allow smaller companies to trade at wider tick sizes. In June 2014, the SEC directed the equity exchanges and FINRA to act jointly in developing and filing a national market system plan to implement a tick pilot program.[11] The Commission noted particularly that a pilot program could facilitate studies of the effect of tick size on liquidity, execution quality for investors, volatility,

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[10] Securities Exchange Act Release No. 64437, 76 FR 27710 (May 12, 2011).

[11] Securities Exchange Act Release No. 72460, 79 FR 36840 (June 30, 2014).

market maker profitability, competition, transparency, and institutional ownership in the stocks of small-capitalization companies.

The efforts to develop a tick size pilot for smaller companies have progressed over the last year. In November 2014, the SEC published for public comment a national market system plan submitted by the SROs to implement a tick size increase for the stocks of smaller companies.[12] The comment period ended on December 22, 2014, and the SEC is closely considering the comments in assessing how to proceed.[13] The data from the pilot program could help the SEC and market participants assess the impact of wider tick sizes for small and mid-cap companies.

Although widening tick sizes potentially could improve liquidity in smaller company stocks, it may not be a complete solution to the challenges faced by smaller companies as discussed in Section I above. For example, the smallest of these companies have average daily dollar volume of less than $10,000 and bid-ask spreads of more than 28 cents. For these and other smaller company stocks, it appears that other regulatory initiatives are worthy of consideration.

III. Exchange Act Provisions that Govern Venture Exchange Proposals

As with other types of national securities exchanges, venture exchanges are required to register with the SEC. Their rules and other material aspects of their operations are subject to a public notice and comment process, and, ultimately, SEC approval. To approve an exchange rule proposal, the SEC must find that it is consistent with the relevant provisions of the Securities Exchange Act of 1934 ("Exchange Act").

As it did with the BX Venture Market, the SEC will carefully consider any efforts of exchanges to fashion innovative services that are particularly designed to meet the needs of smaller companies and their investors. The SEC will continue to be attentive to both the benefits and potential risks of venture exchanges, with a particular focus on whether it can facilitate capital formation and address concerns about investor protection. For example, venture exchanges must operate in ways that are transparent and forthcoming regarding the risks of investing in venture exchange companies. In general, the SEC has considerable flexibility to interpret the Exchange Act in ways that recognize the particular needs of smaller companies and their investors.

For example, the BX Venture Market adopted quantitative listing standards, such as stockholders' equity, that were lower than those of any other national securities exchange with an active listings program, but these lower listing standards were balanced by rigorous vetting, surveillance, examination, and disclosure requirements to protect investors. In addition, stocks to be listed in the BX Venture Market are not considered national market system securities under

[12] Securities Exchange Act Release No. 73511, 79 FR 66423 (November 7, 2014).

[13] The SEC recently extended the time period for considering the proposed tick pilot plan until May 6, 2015. Securities Exchange Act Release No. 74388, 80 FR 12054 (March 5, 2015).

Section 11A(a) of the Exchange Act. They therefore are not subject to Regulation NMS, which applies only to national market system securities.

As discussed below, several Exchange Act provisions, however, do limit the flexibility available to the SEC in approving any proposed venture exchange models, particularly with respect to how they maximize liquidity in secondary market trading. As evidenced by the market quality statistics above, maximizing liquidity is likely to be essential to the success of venture exchanges.

In this regard, there are a variety of potential initiatives that a venture exchange might explore to promote liquidity. One option would be to limit all trading to particular times of the day or through particular mechanisms. Such an option could include running batch auctions at particular times that are designed to centralize liquidity across both price and time. Another option would be to attract dedicated liquidity providers with a package of obligations for making a market in listed companies, balanced by benefits for providing high-quality liquidity. A third option would be to explore different minimum tick sizes in ways not limited to those under consideration in a tick size pilot.

A key element that likely would be essential to the success of these and other efforts is protecting the liquidity pool on the venture exchange. If trading venues other than the venture exchange could execute trades in the venture exchange's listings and thereby bypass the mechanisms designed to maximize liquidity, the effectiveness of these liquidity-enhancing mechanisms might well be impaired.

Trading volume in U.S.-listed equities today is widely dispersed across a variety of different venues, including 11 exchanges, 46 dark pool ATSs, and more than 200 broker-dealers. This dispersal of trading volume is even greater for the stocks of smaller companies. For example, the table below breaks out the trading volume in January 2015 across the three tiers of NASDAQ-listed stocks – NASDAQ Global Select ("NGS"), NASDAQ Global Market ("NGM"), and NASDAQ Capital Market ("NCM"). The initial financial and liquidity requirements for the NGS tier are higher than those for the NGM tier and, likewise, the initial listing requirements for the NGM tier are higher than those for the NCM tier.

Table 4 Dispersal of Volume Across NASDAQ Listing Tiers[14]				
Listing Tier	**Total Volume**	**NASDAQ**	**NASDAQ TRF[15]**	**Other Exchange and TRF**
NGS	81.45%	29.02%	30.78%	40.19%
NGM	11.73%	20.47%	36.13%	43.40%
NCM	6.82%	22.06%	41.54%	36.40%

These data show that stocks in the NASDAQ listing tier (NGS) with the most extensive listing requirements account for the largest share of trading volume, relative to stocks in the bottom two listing tiers. When considering the composition of trading volume by trading venue for stocks in each NASDAQ listing tier, NASDAQ exchange trading accounts for a larger share of trading volume (29.02%) for stocks in the highest listing tier relative to stocks in the bottom two listing tiers (22.06% and 20.47%). Conversely, the off-exchange portion of trading (represented by NASDAQ TRF) accounts for a smaller share of trading volume (30.78%) for stocks in the highest listing tier, relative to stocks in the bottom two listing tiers (41.54% and 36.13%).

The broker order-routing practices that led to these statistics for NASDAQ-listed securities would likely be similar for venture exchange-listed securities. As a result, venture exchanges might seek to adopt rules applicable to their members, or request the SEC to adopt market-wide rules applicable to all exchanges and broker-dealers, that limit the extent to which other venues could bypass the venture exchange's mechanisms for centralizing and maximizing liquidity.

Two Exchange Act provisions provide standards for the SEC to adopt or approve measures to protect the liquidity pool of a venture exchange.

Section 11A(c)(3) authorizes the Commission to prohibit broker-dealers from executing transactions otherwise than on an exchange, provided that the Commission is able to make certain findings. For example, Section 11A(c)(3)(A)(i) requires a finding that the fairness or orderliness of the markets has been affected in a manner contrary to the public interest or the protection of investors, and Section 11A(c)(3)(A)(iii) further requires a finding that the maintenance or restoration of fair and orderly markets may not be assured through other lawful means under the Exchange Act. Moreover, Section 11A(c)(3)(A)(ii) requires a finding that "no rule of any national securities exchange unreasonably impairs the ability of any dealer to solicit or effect transactions" for its own account. Accordingly, Section 11A(c)(3)(A) imposes a substantial test for the Commission before it can adopt rules that restrict the ability of broker-

[14] *See* NASDAQ OMX, Inc., *available at* https://www.nasdaqtrader.com/trader.aspx?ID=marketsharedaily. The column for Total Volume captures relative trading volume across the three tiers of NASDAQ-listed stocks, while the columns for NASDAQ, NASDAQ TRF, and Other Exchange and TRF capture relative trading volume within each listing tier.

[15] The NASDAQ TRF (Trade Reporting Facility) reflects trades reported by off-exchange venues. Across all NASDAQ-listed stocks, the NASDAQ TRF represents approximately 93% of off-exchange volume. The other 7% of off-exchange volume in NASDAQ-listed stocks is reported to the NYSE TRF.

dealers to execute off-exchange trades in stocks listed on venture exchanges. It is worth noting that Section 11A(c)(3) was adopted in 1975, when a major congressional concern was the dominance of trading volume by the major stock exchanges in their listings.

The other Exchange Act provision limiting the extent to which a liquidity pool of a venture exchange can be protected is Section 12(f), which was enacted in 1994. It generally grants exchanges the right to trade securities listed on other exchanges ("unlisted trading privileges" or "UTP") as long as the UTP exchange has appropriate rules in place to govern such trading. As with Section 11A(c), Congress adopted Section 12(f) when the major stock exchanges dominated trading in their listed companies. In the context of initial public offerings ("IPOs"), the statute gives the Commission authority to delay unlisted trading in IPO shares for a certain period after the IPO's launch, with Section 12(f)(1)(C) setting an initial interval of two trading days. Consequently, even with respect to IPOs, Section 12(f) presents a meaningful test for approving an extended period when exchange trading may occur only on the listing exchange, particularly for periods sufficient to enable smaller companies to reach adequate levels of liquidity such that UTP restrictions were no longer reasonably necessary.

Of course, the Commission would need to carefully evaluate whether rules protecting the liquidity pool of a venture exchange would serve the needs of small companies, their investors, and the broader markets. Simply allowing a venture exchange or its liquidity providers to enjoy monopoly trading privileges would not be the justification or objective, and such rules could be approved only after a full opportunity for public notice and comment. As with any rule where the Commission must determine whether an action is necessary or appropriate in the public interest, the Commission must also consider the protection of investors and whether the action will promote efficiency, competition, and capital formation. Moreover, the Commission would have to evaluate whether and when any period of liquidity pool protection would need to end if a listed company reached significant size and levels of liquidity.

The Commission must also consider how efforts to protect a venture exchange's liquidity pool would affect competition. While such efforts would restrict one form of competition – that is, competition among trading venues for order flow in a particular group of securities – it could potentially open up new forms of competition. Multiple venture exchanges might compete to fashion market structures designed to maximize liquidity for small companies and investors that currently are unavailable under the existing Exchange Act regulatory scheme. Such competing venture exchanges could be created by existing exchange groups or others, such as groups of dealers who believe they have the ability to offer innovative and competitive services to smaller companies. It is also possible, however, that high costs and other barriers to entry, such as network effects or cost-related economies of scale, may result in a more concentrated market with few active venture exchanges. The success or failure of the exchanges would largely depend on the extent to which the various venture exchanges were able to attract small companies and their investors.

In sum, competition in the equities markets can assume many forms across different stages in the listing and trading process. A key policy question is whether the current U.S. market structure for smaller companies enables competition in ways that ultimately redound most to the benefit of smaller companies and their investors. Particularly if combined with

strong measures to promote investor protection and market integrity, opening up new forms of competition in the listing and trading of smaller companies potentially could offer significant benefits to smaller companies and their investors. Conversely, protecting the liquidity pools of venture exchanges in their listings and thus eliminating off-exchange competition for trading volume from broker-dealers may affect execution costs, resulting in potentially larger transaction costs for investors. The potential benefits and costs of various forms of competition in the secondary market for smaller companies is an issue that warrants close consideration by Congress, the SEC, and the public.

IV. Conclusion

Thank you again for inviting me to discuss an issue of such importance to the U.S. equity markets and economy. I look forward to answering your questions.