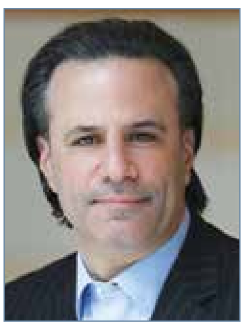
The Case for Deregulating Small Caps

By Adam J. Epstein



Adam J. Epstein was an institutional investor who now advises pre-IPO and small-cap boards through his firm, Third Creek Advisors LLC. He is the author of *The Perfect Corporate Board: A Handbook for Mastering the Unique Challenges of Small-Cap Companies* (McGraw-Hill, 2012).

There are roughly now half the number of companies listed on the Nasdaq Stock Market and the New York Stock Exchange as there were in the mid-1990s, and there is no shortage of dire media pronouncements about what it all means. The alarmists tend to share the same economic biases, and the arguments in favor of more exchange listings gloss over some market exigencies.

Stock exchanges, venture capitalists, investment banks, law firms, auditors, and accountants are the most vocal constituencies in their support for more public companies, and all have one important thing in common: they would directly profit from more public companies.

Yet institutional investors, which are the primary consumers of initial public offerings (IPOs), rarely express a desire for more public companies. It is also worth noting for those who reference concern for how fewer public companies might disadvantage nonprofessional, or so-called "retail," investors, that there are no newspaper opinion pieces or organized marches in Washington demanding more IPOs.

Of course, just because those who are the primary proponents of more public companies also share an obvious conflict of interest doesn't mean that their arguments are invalid. Nasdaq, NYSE, and the National Venture Capital Association have compelling data to suggest that public companies, among other things, add quite a bit more value to the economy than private companies.

But even if you give the benefit of the doubt to those who advocate for more public companies, there would need to be some material changes to today's capital markets to accommodate the increases sought. The overwhelming majority of public companies are small cap, and if companies were to return to undertaking IPOs earlier in their life cycles, as advocates suggest, the resulting increase in public companies would predominantly increase the number of small-cap enterprises.

Today's one-size-fits-all approach to capital markets doesn't benefit the shareholders of many small-cap companies. Subjecting a 10-person biotech company with a $300 million market cap to substantially similar rules and regulations as those that govern, say, IBM, imposes unsustainable costs and operating burdens on that smaller company.

To make matters worse, those disproportionate sacrifices aren't offset by the capital markets advantages that larger public companies enjoy—by some estimates, one-third of exchange-listed companies have no equity research coverage.

And the picture for exchange-listed small-cap companies gets worse when you consider the trading liquidity of their stocks. As I proffered during my 2018 testimony at the US Securities and Exchange Commission (SEC), rampant small-cap illiquidity has wide-reaching, deleterious effects on small caps; that is, it severely impacts access to capital, it makes stock prices more volatile, it makes it harder to attract and retain employees, and illiquid stock cannot readily be used as currency to buy other companies.

To help quantify the pervasiveness of illiquidity in the small-cap ecosystem, the SEC's April 2018 *Empirical Analysis of Liquidity Demographics and Market Quality for Thinly Traded NMS Stocks* concluded, in part, that roughly half the stocks listed in the National Market System have average daily trading volume below 100,000 shares. To put that into perspective, Apple's stock trades about 26 million shares per day.

While reasonable people can differ about why certain groups seem to advocate so strenuously for more public companies, and whether more public companies is objectively a good thing or not, it is somewhat fanciful to think that the austere capital market challenges experienced by small-cap companies are somehow going to vanish simply by adding lots more of them.

On the other hand, most everyone can probably agree that a good first step is for regulators and legislators to help make capital markets work for the small-cap companies we already have.