

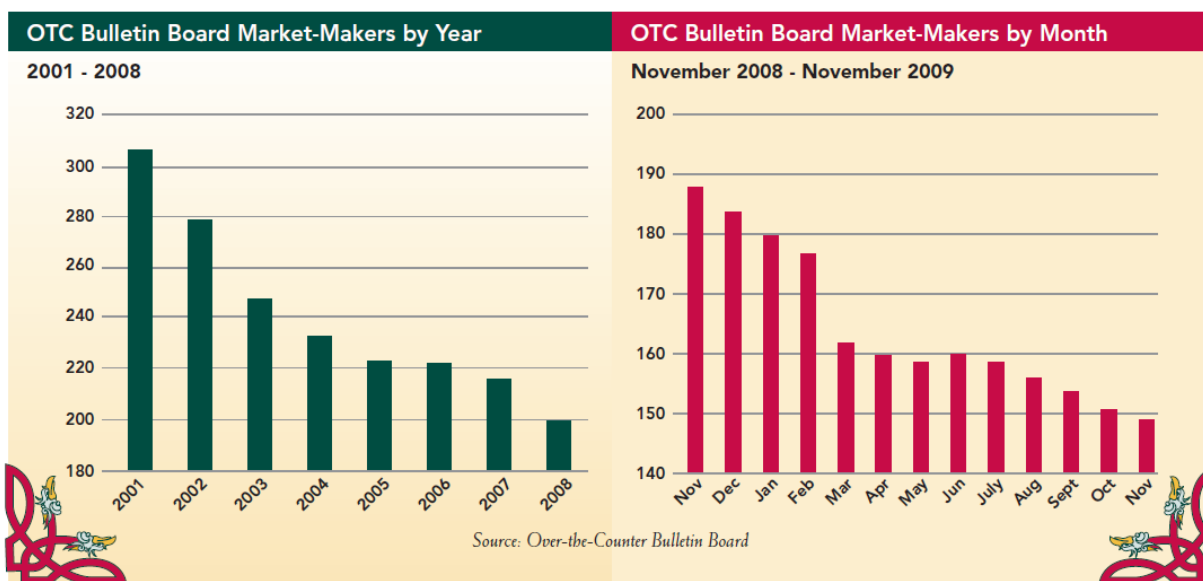
## OPINION

by Timothy J. Keating

### Erosion of Aftermarket Support: The Double Whammy of Unintended Consequences

**W**e have written in the past about the many factors that have conspired to compromise the traditional, underwritten IPO, particularly for smaller issuers that raise less than \$50 million in a public offering. The causes of the extinction of the small IPO include: Sarbanes-Oxley, Regulation FD and the Spitzer “global settlement” on equity research. But it’s not only the primary market that has been affected. Although less headline grabbing, the knock-on effects of these ill-conceived “reforms” have also had insidious impacts on the pillars of the aftermarket, namely research and trading.

Consider research first. According to a recent study, a full 40% of all stocks traded on Nasdaq had no research coverage. You read that right—not a single analyst following the stock. A further 20% of Nasdaq companies had only one analyst. Now let’s take a look at trading. In 2001, there were an average of 306 market-makers quoting prices in stocks trading on the Over-the-Counter Bulletin Board. That number has declined steadily each year through 2008, when only 199 firms made markets. Looking at the rather grim data for the past 12 months, the number of market-makers has declined steadily from 188 in November 2008 to 149 in November 2009. The charts below tell the story with alarming clarity.



According to data from SIFMA (Securities Industry and Financial Markets Association), as recently as 1990, nearly one quarter of all broker-dealer net revenue was attributable to trading gains. That number has also

steadily eroded to approximately 9% this decade, with 2007 (a good year) showing a negative 3% contribution—the first loss in the last two decades. While “decimalization” has surely played a part in declining spreads, it has also served to dramatically increase volumes—but only in the largest, most liquid stocks.

As if the perception of the difficulty and cost of complying with Sarbanes-Oxley were not enough to deter private companies from seeking to obtain public company status, now there is an eviscerated aftermarket—with vanishing research coverage and market-making—to finish the job. Talk about a one-two punch.

A rational and free market for small business capital formation will create more new companies, innovation and jobs than any stimulus from Washington ever can. In addition to making it easier for companies to go public in the first place, genuine reform is needed in the aftermarket to dramatically lighten the burden on broker-dealers who would otherwise be willing to provide research coverage and make markets in these stocks.