Dodd Frank: Boon for Large Caps, Bust for Micro-caps

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The passage and implementation of Dodd-Frank has had a profound impact on the markets for all US stocks. Under Dodd-Frank for the first time in the history of the US, a broker became criminally liable for recommending stocks which then decline substantially in price. This has resulted in a boon for large cap stocks and a continuing expansion of their multiples and valuations of these large companies. Conversely, the Dodd-Frank Act has caused a bust for low-priced share and micro-cap companies as well as a continuing contraction of their multiples and valuations. The graph below depicts the performance comparisons for the Royce Price Stock Index from 1995 through 2017.

The passage of the Dodd-Frank Act in 2010 was a consequence of the crash of 2008. The origin of the act, which the SEC began to implement in 2012, was expressly for the purpose of preventing another crash like that of 2008.

In an regrettable ironic twist**, it will be Dodd-Frank that will be the cause of the next crash** since it is the primary contributor to the expansion of the S&P 500's PE multiple. Dodd-Frank strengthened the SEC's enforcement powers and for the first time ever added criminal liability for US stock brokers who recommend shares to clients which decline significantly. The resultant dynamic was a mass exodus of the brokers into the wealth management industry.

> *Many of whom I have shared this information with were shocked to the point of disbelief that a broker for the first time ever could be criminally prosecuted. This link to a law journal delves into Dodd Frank's criminalizing conduct for the first time.Prior to Dodd-Frank a broker's liability for recommending an investment gone sour was a civil arbitration proceedings. There was case that I found in a December 2014 law journalwhere a broker and a registered investment advisor were criminally prosecuted for recommending the shares of a small company at a*

*price that "had no relationship to the company's true worth". See page 22 of law journal. This is very scary. The market prices for all stocks throughout my 40 year career and up until Dodd-Frank was passed, were based on the **future** and not on **current or past** financials. The precedent that has been set, especially for the criminal prosecution of a registered investment advisor who had purchased shares for clients that were valued for a premium over their book value for clients is extremely dangerous. I predict that eventually the public markets, for the shares of all but the biggest companies, will disappear.*

To avoid the legal liabilities added by Dodd- Frank, the broker dealers converted their "commissions-per-transaction" stockbrokers into wealth managers to instead sell a "fee-based-on-assets-under-management" product. Diversified portfolios consisting of large cap stocks are immune to criminal prosecution. As a result, when the entire market crashes no one is to blame.

The change in compensation from commissions to fees has propped up the S&P 500. The wealth management industry and its advisors are highly motivated to keep the clients in stocks. The advisors know that when a client converts to bonds the fee is much lower and when into cash, the client can no longer be charged an annual percentage fee based on the assets under management. This, of course, begs the question "is the client best served with this strategy when a neutral party might suggest that a high percentage of the portfolio be in cash or in the bonds of sovereign nations would be wiser or safer?"

The passage of Dodd-Frank was a blessing for the broker dealers in the US. It substantially reduced a broker dealers' potential liability which they had when their representatives picked their own stocks for their clients to invest. The fee based on "assets under management" model instead of the" commission per transaction" model has resulted in the income streams for the broker dealers becoming much more stable. Please see, "Outlook for the US Wealth Management Industry: "The Most Exciting Time", January 27, 2015.

With the stockbroker becoming extinct, those companies having low priced shares and small market capitalizations were left to fend for themselves. Any wealth manager who might recommend them or assist them to raise capital could potentially face prison time. The companies and their investors now have to deal with a new scourge. The market for low-priced stocks and small-cap companies is now rife with lenders who provide loans which have extremely toxic anti-dilution clauses and manipulative short sellers who prey on an unsuspecting public.

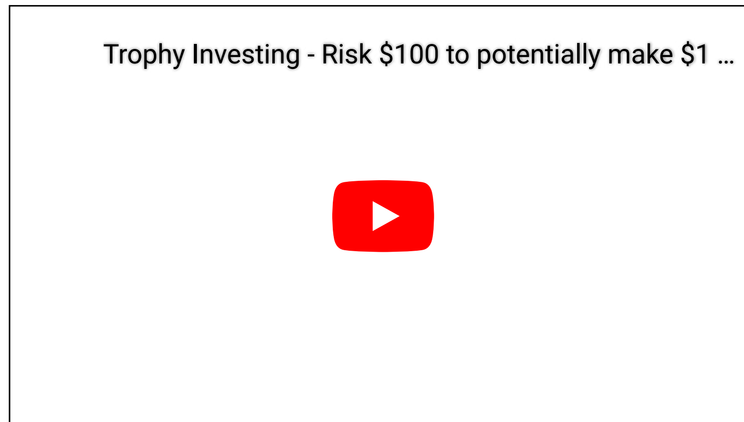
The only solution for publicly traded companies with market caps of less than $200 million and have less than 2,000 shareholders is to convert from a public to a private company. The conversion from public to private company would enable a small company to raise capital from the crowd under Regulation CF and Regulation A+ of the JOBS Act. Public companies can-not utilize these regulations to raise capital.

Entrepreneurs who are considering to take their small private companies public by merging into a shell should refrain from doing so. Investors should avoid investing into the shares of small public companies and penny stocks like the plague.

Entrepreneurs seeking capital and investors who are looking for substantial returns from investing in small emerging growth companies should instead look to participate in crowdfunding. It's the future of the capital markets and especially for small emerging growth companies for three primary reasons:

- With the SEC's lifting of its last remaining crowdfunding ban that had been in place since 1933 anyone who is not affluent can now invest as little as $100 into a startup to make a significant amount. View video below entitled "Risk $100 to potentially make $1 million".
- Entrepreneurs can raise up to $1 million per year from the crowd under a Title III offering and $50 million per year under a Title IV offering. The shares issued under a Title IV offering are unrestricted.

- StartEngine, a leading regulated crowdfunding platform recently established a secondary market for the shares of private companies with market caps of less than $1 billion.This happening has resulted in the following:



- Capital markets being transformed. See November 17, 2017 article by Michael Markowski entitled "StartEngine's New Secondary Market Extremely Disruptive to Capital Markets".
- Crowdfunding now on path to become ubiquitous by 2020.
- StartEngine becoming a first mover and its market cap increasing ten-fold by 2019. See Michael Markowski's November 17, 2017 article entitled "Shares of StartEngine Poised to Multiply in 2018".

Even if Dodd-Frank is repealed, the world has forever changed. The successful convictions under the new laws have established a legal precedent that the SEC and government will use to prosecute in the future unless the convictions for those who were convicted under the new laws are overturned. To further the nails into this coffin is the fact that President Trump is a not a stock market guy and his treasury secretary is from Goldman Sachs. Therefore, the probability is low that a Department of Justice under the Trump administration would go so far as to overturn convictions related to shares of small companies.

Mr. Michael Markowski is a 40 year veteran of the securities markets. His conducting a post mortem on Enron enabled him to develop an algorithm to enable him to predict bankruptcies for seemingly healthy public companies. This included his predicting the demise of Lehman, Bear Stearns and Merrill Lynch in his "Winners and Sinners" Equities Magazine column. See "Have Wall Street's Brokers Been Pigging Out".

Michael Markowski is currently the startups expert for Trophy Investinga member based-investing community which excels in identifying the shares of startups and early stage companies that have the potential to multiply in price within three to five years after investment.Membership to Trophy Investing is free. Additional information about Mr. Markowski is available at http://www.michaelmarkowski.net/.

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