CUG.COMments

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Underwriters of D & O and Professional Liability Insurance

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In this issue … the relentless decline in publicly listed companies.

Since a high-watermark of 8,823 in 1997, the number of companies listed on the New York Stock Exchange (NYSE Euronext) and the NASDAQ Stock Exchange (NASDAQ OMX) has experienced a steady decline. This issue of CUG.COMments looks at this trend and possible implications.

BACKGROUND

At the end of 1997, according to data compiled and published on its website by the World Federation of Exchanges (WFE), the number of public companies listed on the New York Stock Exchange was 2,626; the number listed on NASDAQ was 5,487, and on the American Stock Exchange (AMEX) there were 710. This produced a combined total of 8,823 listed companies (all WFE U.S. data excludes investment funds).

At the end of 2011, the total of NYSE and AMEX (which had merged in 2009) was 2,308, while the NASDAQ count was 2,680. This combined total was 4,988, which was 3,835 fewer than in 1997, representing a reduction of 43%. What had happened?

For some commentators, the Sarbanes-Oxley Act is a prime culprit. A Wall Street Journal article in May 2011 refers to "the burden that the … Sarbanes-Oxley law places on firms seeking to join the public markets" and how the "pace of U.S. initial public offerings has never recovered since the enactment of Sarbox." However, Sarbanes-Oxley became law in 2002 and the Initial Public Offering (IPO) data does not necessarily support that contention. According to data compiled by the widely respected IPO monitor Professor Jay Ritter of the University of Florida, IPO frequency had already fallen from 397 in 2000 to 85 in 2001, and then dropped again to 74 in 2002. The numbers certainly showed little improvement in 2003 —just one more, to 75— but two years after Sarbanes-Oxley the IPO frequency was up to 196, and increased further during the next two years.

THE IPO SCARCITY

Even if Sarbanes-Oxley was not a leading cause of the IPO decline, the data from 1991 to the present still show a significant overall reduction in IPO activity. As the historic source for replenishment of public company listings, IPOs have not kept pace with the attrition.

Professor Ritter's site shows IPOs averaging 484 a year from 1991 through 2000, but only averaging 136 a year from 2001 to 2010. The highest year being 1996 (705 IPOs), and the lowest 2008, with only 36.

Companies can become listed on the major exchanges through ways other than the classic IPO: Some migrate from the over-the-counter market; some utilize the reverse-merger approach. On the other side of the ledger, companies leave the exchanges for different reasons: Some file for bankruptcy, some are taken private and some are acquired; IPOs that might have launched in the USA may be taken overseas. The nature of public company listings and delistings is complex and fluid. Overarching causes for the changes are therefore hard to state with certainty, but two facts remain clear: Public company listings have declined steadily since the turn of the 21st century, and the number of IPOs has been insufficient to completely compensate for that decline.

IMPLICATIONS FOR THE U.S. ECONOMY

According to a 2009 study by Grant Thornton ("A Wake-Up Call For America"), the implications for the U.S. economy of what they call the "Great Depression in Listings" are significant. The study suggests that as many as 22 million jobs may have been lost from 1997 to 2008, a staggering estimate.

Few would argue that massive job losses are unimportant, but public companies are not the only element in the U.S. economy. According to data provided by the Small Business Administration, of the 5.93 million firms with employees in 2008, 5.82 million of those firms had fewer than 100 employees, amounting to around 42 million employees, or nearly 35% of the total non-governmental workforce. Financial news typically focuses on companies listed on the major stock exchanges and so it is easy to overlook the contribution made by the generally unremarked but significant small-business sector.

Even as the number of publicly traded companies began its downward spiral in 1997, the economy as measured by the GDP (Gross Domestic Product) has continued to expand, the one exception being 2009. It's probably an exaggeration to suggest that the economy has shrugged off the dwindling numbers of listed companies, but neither has that reduction dealt the economy a mortal blow.

IMPLICATIONS FOR THE U.S. PUBLIC COMPANY D&O MARKET

Turning from possible macro-economic effects to the niche sector of public company D&O insurance, the first and simple conclusion is that there are now considerably fewer buyers of D&O insurance than there were in 1997. A D&O underwriter in 1997 could survey a universe of 8,823 potential applicants from the major stock exchanges. By the end of 2011, that universe had shrunk by 43% to 4,988.

The fundamental supply and demand equation applies as much to commercial insurance as to any other economic activity. Historically, the anecdotal assumption has been that buyer demand for commercial insurance was relatively steady —even expanding. That assumption left the periodic rise and fall of supply through carrier choice or financial winnowing to largely determine market pricing. Prior to 1997 this premise of stable or increasing demand was valid: 6,765 public companies in 1990 and 8,823 in 1997. But the following 14 years disrupted that hypothesis as the universe of buyers shrunk, and with it demand.

Meanwhile, the supply of D&O insurance has been generally increasing over the same period. Aside from constriction in certain market segments stemming from the financial crisis, there may be more D&O insurers and capacity now than ever before.

SUMMARY

The resilience of the small-business sector has provided invaluable support to the U.S. economy, but a vibrant publicly traded sector is also important for job creation and especially wealth creation. A shrinking universe of publicly traded companies is ultimately detrimental to the U.S. economy, and particularly so for providers of public company D&O insurance. It is telling that even as U.S. listings have declined, those in other parts of the world have increased. The number of listed companies on the Hong Kong Exchanges in 1997 was 658; by the end of 2010 there were 1,413. Over the same period the Singapore Exchange saw growth from 334 to 778 and the Tokyo Stock Exchange increased its numbers from 1,865 to 2,293.

For D&O insurers, the expansion of Side-A Only programs during the past several years has provided a new source of premium income even as the premiums from "standard" policies have fallen, which could have helped delay any market adjustments. However, the decline in U.S.-listed companies is probably a factor that should feature in any attempt to anticipate future market direction.

A Note On Data

All data on the number of public company listings is taken from the World Federation of Exchanges, which provides a consistent format. Reliable IPO data can be more elusive, as each data provider applies its own filters to the numbers. For IPOs, data from Professor Jay Ritter of the University of Florida is used. However it would be wrong to tie the data elements together; they reveal similar clear trends with data based on criteria that largely overlap, but are not identical.❖

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