

Introduction

Conference on the Interim Report of the Committee on Capital Markets Regulation

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There have been three reports within the last few months on whether the United States is losing its preeminence in the world's financial system. The first of these is the report we will discuss today, the Interim Report of the Committee on Capital Markets Regulation. Later reports were prepared by Mayor Michael Bloomberg and Senator Charles Schumer, and by the U.S. Chamber of Commerce.

In a sense these reports complement each other. The Bloomberg-Schumer report rested heavily for its original content on a survey of business leaders; the Chamber of Commerce report focused on recommendations that could be addressed administratively rather than by legislation and were thought to be relatively noncontroversial. The Capital Markets Committee report relied on data and scholarly work, marshalling academic studies to make its case. For that reason, it is at once the most interesting and the most persuasive.

Using their different approaches, however, all three studies came to the same conclusion—that excessive regulation and high litigation risk was impairing the ability of the U.S. financial economy to compete with venues around the world. Those who are skeptical of this conclusion will note that the increasing popularity of foreign securities markets is the result of their growing maturity, and that they have simply learned from us the entrepreneurial skills necessary to make these markets thrive. But the survey data in the Bloomberg-Schumer report and the academic analyses we will discuss today suggest that is only part of the challenge. While our competitors have grown stronger, we have weakened our own position by allowing regulation and frivolous litigation to go too far—to go, in effect, beyond the tipping point.

At some level, regulation enhances the attractiveness of a market by providing investors with confidence about the honesty of the game, but when it goes beyond that level it becomes counterproductive and drives transactions away. This can actually be expressed in dollars and cents. It used to be, for example, that the premium a company would receive from a listing on the New York Stock Exchange far outweighed the added costs of regulation and litigation risk. A listing in the United States—and especially on the venerable NYSE—was said to act like the iconic Good Housekeeping seal of approval, giving investors confidence that if a company had passed the rigorous regulatory tests necessary to list on the NYSE, the risks associated with investing in it were significantly reduced, making for a higher stock price. However, the reverse is also

true. If regulation gets too expensive, the decline in fraud risk is increasingly matched by needless regulatory costs until the premium is fully eroded. There are indications that this may be happening in the United States. The Capital Markets Committee report cites the decline in the premium for a NYSE listing as evidence for the proposition that foreign companies see diminishing value in a U.S. listing. No one can cite a point where the crossover will occur, but the migration of financial transactions out of the United States is probably telling us something.

It is reasonable to ask, however, whether this is anything to be alarmed about. So what if financial transactions are migrating abroad? Is this any different in substance from the outsourcing of other functions that were formerly performed in the United States? Might this not be the result of the comparative advantage of foreign venues in a globalizing world? In other words, are we, traditional supporters of free trade, beginning to sound like Lou Dobbs when foreign competition might be affecting our own jobs?

I think not. The financial economy in this country is vital to its growth in a number of areas. It's not so much that financial transactions are moving abroad, it's that the forces that are sending them abroad could also adversely affect economic growth and the general welfare here in the United States. Let me give two examples.

There is increasing evidence that the high cost of becoming and remaining a public company in the United States is adversely affecting the process of incubating and developing innovative new technology companies. Traditionally, venture capital firms provide seed financing that enables fledgling companies to develop their ideas and products until they are mature enough to access the public markets through an IPO. The IPO was the VC's exit strategy. However, because of the costs heaped on public companies—not just Sarbanes-Oxley, but many other costs tangible and intangible—it does not make financial sense anymore for many small companies to access the public markets. Frequently, an IPO is no longer a viable exit strategy. As a result, all too often, VCs are selling their venture clients to established companies that have incentives to suppress a new technology rather than develop it.

This could have a substantial adverse effect on economic growth in the United States. As the Capital Markets Committee report notes, "About 40 percent of U.S. employment in publicly traded firms as of 2000 was accounted for by firms that were nurtured by venture capital and subsequently listed in the 1980s and 1990s." By cutting off the access of newly developing firms to the inexpensive capital that fueled the growth of our tech industry, we risk shutting down one of the principal engines of our and the world's prosperity. For this reason, an AEI conference on May 10 will explore this issue in greater depth.

In addition, sharply declining foreign securities listings in the U.S. suggests that foreign companies are reluctant to bear the costs and risks associated with share ownership by U.S. investors. This unhappy fact seems confirmed by the recent disclosure that in 2006 foreign companies raised more equity financing in private transactions in the United States than they raised on *all* U.S. exchanges combined. This is quite a telling statistic, given the fact that the cost of such capital in the public markets is about one

percent lower than in the private markets. If foreign companies have become wary of exposure to the liabilities associated with public share ownership in the United States, U.S. investors could be denied easy access to foreign companies and even foreign securities exchanges in the globalized capital markets of the future. The loss of opportunities for asset diversification and participation in world-wide economic growth would be a serious blow to U.S. investors.

In other words, what we are doing through excessive regulation and litigation risk to make our public securities markets less attractive for both U.S. and foreign firms could have profound and long term effects on U.S. economic growth and the general welfare of the American public. It is not the same thing as outsourcing jobs to other countries—even skilled jobs—because the health of the financial markets are central to the health of the rest of the economy.

In today's conference, we will consider four of the topics addressed in the Capital Markets Committee's report—Federal-State Relations, Litigation Reform, Reform of the SEC and Shareholder Rights. These topics do not exhaust by any means the scope of the study, but they address some of the more salient issues that the Committee considered. Together they provide an important perspective on whether the United States is in danger of losing its leading role in the world's financial system. For our luncheon speaker, we are fortunate to have SEC Commissioner Paul Atkins.