

The Second Report of the Committee on Capital Markets Regulation

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Introduction

Peter J. Wallison

If it were still necessary to demonstrate that the US is losing its pre-eminence in the financial world, the most recent report of the Committee on Capital Markets Regulation seems to settle the issue. This committee, made up primarily of academics and financial markets specialists and put together by Hal Scott, was the first to report on this trend in November 2006. The Committee's report was followed in 2007 by reports of the U.S. Chamber of Commerce, New York's Mayor Bloomberg and Senator Schumer, and most recently by the Financial Services Roundtable.

Skeptics' initial reaction to the Committee's first report was to question whether what we were seeing was actually a decline in the U.S. market or just the maturing and growth of foreign markets. Certainly foreign markets are growing, but much of the data in the Committee's latest report seems to confirm that there is more going on than greater competition from foreign markets. The data is consistent with a conclusion that foreign and even U.S. companies are actively seeking to avoid the U.S. public markets.

The enormous growth of the 144A market, for example, where foreign companies can raise equity funding without having to register with the SEC, is hard to understand unless it reflects an effort to avoid the U.S. public securities markets and the litigation risk that these markets entail. This fact has always been particularly striking for me, because public equity is supposed to be less expensive for companies than private equity, which is not only more costly to raise but is raised from demanding sources that diligently monitor their investments. Yet the growth of 144A transactions, as we will see, has been extraordinary.

This and quite a bit of additional data in the Committee's latest report seem to make a powerful case for the proposition that the U.S. public securities markets are losing their favored position as a place to raise capital. If so, it is very bad news not only for brokerage firms and the exchanges themselves, but also for U.S. investors, who are losing opportunities to diversify their investments and thus reduce their risks. The irony here is that the purpose of securities regulation is to reduce risk for investors, but by reducing opportunities for diversification the regulation is having the opposite effect.

Like global warming, this is an issue with two distinct questions: is it really happening, and if so, what are the causes? The data in the Committee's latest report, at the very least, places the burden on skeptics to advance a different explanation for what is happening; in my view, it comes as close as one can in social science to demonstrating that U.S. and foreign companies are shunning the U.S. public markets. The salient question now is what is causing this trend.

The Committee's initial report, and all the reports that followed, placed the blame for the decline of U.S. pre-eminence on excessive regulation and litigation risks. This is certainly plausible. The decline seemed to begin after the Sarbanes-Oxley Act was adopted in 2002. The London Stock Exchange advertises itself as a Sarbanes-Oxley-free zone and has experienced a boom in listings since SOX made its appearance.

It is not difficult to imagine that there is a tipping point in regulatory costs, when the benefits of regulation—the reduction in many of the operational risks associated with investing—begin to be outweighed by the cost burden they impose. When the tipping point is passed, companies begin to recognize that they don't get any *net* value from entering a regulatory regime. SOX may have pushed the U.S. past that tipping point.

A similar case could be made for litigation risk. The Committee's initial report made a strong case against private class actions, pointing out that they were simply a transfer from the one group of shareholders to another, with a substantial cut taken out by the lawyers on both sides. The Bloomberg-Schumer report was particularly strong on this issue, reporting the results of a survey in which U.S. and foreign executives both saw doing business in the U.S. as presenting considerably more risks of expensive litigation and arbitrary results than doing business outside the U.S. This is bound to reduce the interest of foreign companies and even U.S. companies in offering securities or engaging in other financial transactions in the U.S.

The Treasury Department is now in the midst of a serious review of regulatory structure in the U.S.; its officials are well aware of the data in the Committee's most recent report. The question for them, and for us, is whether the move away from the U.S. public markets is a statistical blip, a consequence of excessive regulatory costs and litigation risk, or the result of something else. What they conclude about causes will determine what their recommendations turn out to be.

One of the purposes of this conference is to offer additional perspectives on this key question.