Extraordinary Popular Delusions and the Madness of Crowd (Funding)

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Imagine what Charles Mackay, the author of 1841's *Extraordinary Popular Delusions and the Madness of Crowds*, would think of Congress's latest "jobs bill" and, in particular, its proposal to "crowd fund" enterprises through the Internet. If we picture the mania associated with the South Sea Company, Mississippi Company and Dutch tulip bubbles combined with the power of the Web, we can probably get a pretty clear idea. Unfortunately, Mackay's seminal work doesn't appear to be on many congressional reading lists.

Last week, in what *New York Times* writer Jonathan Weisman called "the closest thing to a kumbaya moment Congress has seen for a while," Speaker of the House Eric Cantor released his JOBS Act with plans to bring it to the House floor for a vote this week. A package of "small company capital formation" bills, most of which have already passed the House separately, the JOBS Act would undermine market transparency, roll back important investor protections, and, if investors behave rationally, drive up the cost of capital for the small companies it purports to benefit. So naturally it has strong, bipartisan support. It is expected to sail through the House, and President Obama has made clear that he can't wait to sign it.

Although the bills making up the JOBS Act are typically described as "non-controversial," they have been severely criticized by leading securities law experts and are opposed by investor advocates and unions, among others.

- In testimony before the Senate Banking Committee, for example, Columbia Law School Professor John Coffee declared that as drafted the "crowd-funding" component of the bill "could well be titled 'The Boiler Room Legalization Act of 2011.'" He said, "It is likely to create "few jobs... and much fraud."
- In testimony before the Senate Securities Subcommittee, Harvard Professor of Law and Economics John Coates cautioned that, in combination, two of the legislation's other components -- one dramatically expanding the exemption that allows small private offerings to be sold to the general public and one greatly increasing the number of shareholders a company could have before it would be required to register -- "would effectively gut the securities laws for all but the largest issuers."
- State securities regulators have warned that a proposal to eliminate the ban on general solicitation in the private offering market would exacerbate problems that already result in significant investor abuse.
- And, I myself have pointed out that the IPO on-ramp portion of the bill encourages companies to go public before they are able to meet the standards designed to ensure that they can provide investors with accurate financial information and protect the right of minority shareholders. That overturns an age-old principle with potentially dangerous implications for the integrity of our capital markets.

In other words, these bills are "non-controversial" in precisely the same way that the Gramm-Leach-Bliley Act was non-controversial when it sailed through the Senate on a 90-8 vote and the House on a 362-57 vote: They have strong support from a business community chafing at what they see as outdated regulations and from political leaders of both parties intent on ignoring warnings that the regulations being rolled back were adopted for a purpose that is still relevant today.

There's another fundamental problem with the JOBS Act. There is absolutely no reason to believe that it will produce any new jobs. As Professor Coffee pointed out in his testimony, the disappearance of small company IPOs in recent years is the result of a variety of factors that have nothing to do with the regulations targeted by the legislation and that the legislation, if adopted, will not change. This point is addressed from a different angle and even more comprehensively in a 2011 academic paper by Jay R. Ritter, Xiaohui Gao, and Zhongyan Zhu. After dispensing with the traditional "blame the regulations" explanation, the report documents a long and steady decline in the profitability of small company IPOs for investors. According to the data, while nearly three-quarters of all small company IPOs showed positive returns for investors in the early 1980s, only about a quarter of small company IPOs each year did so during the past decade. In light of that decline, which was not matched by large companies going public, they posit that "the advantages of selling out to a larger organization, which can speed a product to market and realize economies of scope, have increased relative to the benefits of remaining as an independent firm." Proposed regulatory changes are therefore unlikely to result in more small company IPOs, they conclude.

Professor Coates's testimony offers one additional point that should drive the final nail in the coffin of the deregulation-as-a-means-of-job-creation argument (but won't). Investors respond to weakened protections by demanding an increased risk premium. If Congress continues to erode the regulatory protections for investors in small and not so small companies, as the JOBS Act would do, the rational response from investors would be to drive up the cost of capital, negating and perhaps even exceeding any compliance cost savings that the legislation might produce. That will not be good for the economy.

The millions of out-of-work Americans who are victims of our last experiment with financial deregulation deserve better from their political leaders. While the House is a lost cause, the Senate still has an opportunity to turn this around. Earlier this week, Majority Leader Harry Reid responded to the JOBS Act introduction with an announcement that the Senate was moving forward with its own package of bills. The good news here is that the Majority Leader apparently does not intend to simply accept the House bill as the working text; the bad news is that the Senate appears to be headed down the same "small company capital formation" route to job creation that is unlikely to result in meaningful job growth. The question is whether, in doing so, the Senate can produce a bill that narrowly targets legitimate barriers to capital formation without taking a hatchet to vital investor protections. Unlike the House bill, that, at least, would do no harm.

Charles Mackay had it right well over a century and a half ago when he wrote in his book about financial mania: "Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one." Let's hope our senators are reading their Mackay.