From Congress, a Law Befitting a Sausage Factory

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Whether the Jump-start Our Business Start-ups Act will create jobs or only encourage fraud is open to debate, but one thing is clear: this piece of legislation is a reminder that Congress, both Democrats and Republicans, are completely inept at regulating our financial system.

The JOBS Act is an annoyingly named piece of legislation that purports to create jobs partly by seeking to increase the number of initial public offerings. Companies with up to $1 billion in revenue are labeled emerging growth companies and relieved of disclosure and other securities law requirements for their first five years after going public.

The act also does a number of other things that are wholly unrelated to encouraging I.P.O.'s but intended to make fund-raising easier for companies. Most prominently it allows for so-called crowdfunding. Companies will be permitted to raise up to $1 million through mass, online solicitations via the Internet.

Proponents argue that these changes will unleash the markets from overregulation brought about by the Sarbanes-Oxley Act. Critics are calling this the bucket shop act of 2012. They claim that the JOBS Act undoes important reforms to discourage fraud, prompted by the Enron and WorldCom scandals.

Who's right?

Well, we really just don't know, and this uncertainty is a sad reminder of what a sausage factory Congress is. Congress simply doesn't understand financial markets and instead legislates to the political winds. It is very likely that Congress may have adopted the JOBS Act based on the wrong premise and may end up hurting, rather than helping, markets.

The market for initial public offerings is already fairly robust. The United States has the largest number of offerings so far this year, according to Dealogic.

It is smaller offerings that have been in decline over the years. But the decline of small offerings most likely has very little to do with the changes wrought by the Sarbanes-Oxley Act. Grant Thornton, an accounting and consulting firm that has studied the I.P.O. market found that in 1996, the number of offerings raising less than $25 million was 309, which declined to nine by 2001, a year before Sarbanes-Oxley.

Grant Thornton asserts that the decline is a result of changes in market structure. One reason is decimalization — pricing stocks in cents rather than fractions — that took profits out of trading that had previously given brokers an incentive to list small companies.

But special interests, including the Business Roundtable, were able to tie the decline in small I.P.O.'s to Sarbanes-Oxley and disclosure requirements that were too demanding. Congress bought this argument despite the lack of hard evidence. By doing so, Congress actually ignored evidence that a similar deregulation of foreign issuers in the last decade led to the scandal involving Chinese reverse I.P.O.'s. The Securities and Exchange Commission is now looking to re-regulate that market.

There is a real risk that Congress's actions could harm the market. People pay more for American stocks than they would for those in other countries because we have enhanced antifraud rules. If investors lose faith in the United States market, stocks may decline in value.

As for market structure, the likely reason for the decline in small I.P.O.'s, Congress directed the S.E.C. to study and report whether the stock price of emerging growth companies should be quoted in increments from 1 cent to 10 cents. The commission can then make rules to force shares to be quoted in higher spreads than 1 cent per share.

But making people pay more for these shares would be about as popular as raising the gasoline tax. Congress gave the S.E.C. discretion to make this decision, latitude the agency is likely to use to avoid taking such a step, particularly because it opposes large parts of the JOBS Act. In other words, lawmakers sidestepped the really difficult decimalization issue, leaving it to the regulators in a way almost intended for nothing to happen.

In other areas, Congress also enacted unworkable reforms. The best example is the crowdfunding provision. At the last minute, the Senate amended this provision, ostensibly to enhance fraud protection.

In doing so, Congress made the provisions hard to use. Crowdfunding companies will have to raise money through Internet platforms in small individual amounts, less than $2,000 for most Americans. If a company raises more than $500,000 it will have to prepare audited financials. This is a huge expense that will discourage most companies from resorting to crowdfunding for significant amounts of capital.

Crowdfunding is an interesting experiment and has the potential to democratize fund-raising. But it really is just an experiment.

Congress would have been better off leaving it to the S.E.C. to design and run such an experiment, allowing the commission to tweak the crowdfunding mechanism in light of market developments.

Given the iffy supporting evidence, the whole JOBS Act is an experiment. For this reason, Prof. John C. Coates IV of Harvard Law School has recommended that the terms of the act have a two- or three-year sunset provision allowing for renewal if the provisions are found to work.

Instead this legislation took on the aura of a must-pass to give the illusion Congress was creating jobs. That is why we are getting a major deregulatory bill so soon after the financial crisis. The JOBS Act succeeded because it took the public interest forces by surprise, being pushed out of the House before the problems with the bill could be highlighted.

This is infuriating. If Congress makes a decision based on uncertain facts, then it is using its judgment and doing what we elect them to do. But here the facts, evidence and what was best for the markets simply did not matter.

Tinkering with a multitrillion-dollar market based on sentiment is unlikely to create jobs and help our markets. It is merely foolish.

This is not just a Republican or Democratic issue. The JOBS Act was passed with bipartisan support. Dodd-Frank and Sarbanes-Oxley were similarly flawed. In those acts, Congress made decisions about our

financial markets without even reading or considering the actual facts at hand and often legislated in a manner intended to fail. For another illustration, you only need to look at the travails of the agencies trying to issue the Volcker Rule.

This is both a pro-business and pro-consumer issue. Congress seems to get both the reform part and the raising standards part wrong as special interests control the agenda.

Perhaps the best thing Congress could do for securities regulation in the future is to take a break for a few years and focus on naming post offices.