Capital Market Regulation Needs an Overhaul

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Securities and Exchange Commission Chair Mary Schapiro recently informed the House Committee on Oversight and Government Reform that the SEC is reviewing ideas to reduce the regulatory burdens on small-business capital formation. This should translate into a review of how we regulate offerings in private and public markets. Both need major fixes.

Private offerings, such as those to qualified investors or to large institutions under Rule 144A, do not trigger the mandatory disclosure rules applicable to public offerings. Nor are privately held corporations subject to burdensome public market regulation like Section 404 of the Sarbanes-Oxley Act (requiring internal control audits), which in 2009 cost the average publicly held company more than $2 million in direct costs alone, according to the SEC's own survey.

These advantages help explain why many U.S. companies prefer to remain private, and why in 2010 79.3% of the funds raised in the U.S. by foreign companies in global initial public offerings were raised through the private Rule 144A market.

But there are serious limitations on the use of private markets that need reforming. First, companies can remain private only if they have fewer than 500 shareholders. Shareholder limits impair the liquidity of private-company shares and in turn depress their price.

While transactions in private company shares grew to $4.6 billion last year, this is a drop in the bucket compared to the $1.1 trillion of New York Stock Exchange Group trading volume in NYSE-listed stocks in March 2011 alone. The 500-shareholder limit could be increased significantly, or even eliminated, without endangering investor protection because only qualified investors or large institutions can own these shares.

Short of this, the SEC could make clear that a fund composed of multiple investors counts as one holder of record. The SEC should also allow companies not to count their employees' holdings to avoid discouraging employers from giving their employees stock.

Second, the SEC's rules on private offerings do not permit general solicitation of investors. This prohibits widespread direct mail or ads in general media. This limitation has long been criticized by securities professionals, most recently in 2006 by the SEC's own Advisory Committee. As long as there are limits on who can actually buy shares, what is the harm in broad marketing?

In her letter to Congress, Ms. Schapiro says such limitations have been supported "on the grounds that it helps prevent securities fraud by, for example, making it more difficult for fraudsters to attract investors or unscrupulous issuers to condition the market." The logic is hard to fathom since fraudsters by their very nature will not observe SEC marketing limitations.

This general solicitation prohibition was at issue in Goldman's Facebook offering last year. Reportedly, Goldman was concerned that the general media attention that resulted from unauthorized disclosure of its marketing to highly qualified investor clients would risk violation

of the general-solicitation ban. As a result, Goldman withdrew the offer in the U.S. and instead made it abroad.

While Ms. Schapiro carefully stated in her letter to Congress that at no time did the SEC staff "advise or instruct" Facebook or Goldman that the U.S. offering was improper, she did not deny that the SEC was intensively investigating the matter. At the very least, the SEC should clarify that general media attention, as contrasted with general media marketing, does not violate its solicitation rules.

In her review of ideas to facilitate capital formation by small companies, Ms. Schapiro should not just focus on the private market. Even with relaxation of the number of shareholders and the ban on solicitation, this market will still be dwarfed by the public markets. While the direct-ownership share of U.S. equities by individual investors has greatly diminished (in 2009 it was about 38% compared to about 92% in 1950), it is still important.

Our public markets are increasingly unattractive to foreign issuers, those who have a real choice as to whether to use our markets—unlike large U.S. public companies that are generally trapped here. The U.S. share of global IPOs by foreign companies was 14.2% in 2010, compared to 28.7% from 1996-2006. When the SEC relaxed its requirements for deregistration in 2007, 13.7% of SEC-reporting foreign companies headed for the exits, and they continue to do so.

The SEC review should also focus on how our unique securities class-action litigation system is contributing to this undesirable trend. In 2010, company payouts funded by shareholders amounted to more than $3 billion, and in previous years it's been as high as $17 billion. That's no way to attract foreign companies to U.S. markets.

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