Testimony

of

Richard W. Rahn, Ph.D.

"The Future of Capital Formation"

before

the Committee on Oversight and Government Reform

House of Representatives

Congress of the United States of America

Washington, District of Columbia

May 10, 2011

Mr. Chairman and Members of the Committee:

Thank you for inviting me to testify today on the important subject of capital formation and SEC regulation. I am Richard W. Rahn, a Senior Fellow at the Cato Institute and a syndicated weekly economic columnist. My testimony today reflects my own opinions and views and not necessarily those of any organization with which I have an affiliation.

Over the last few decades, I have served as head of a graduate school of business, a professor of economics, executive director of the American Council for Capital Formation, Vice President and Chief Economist of the U.S. Chamber of Commerce, an economic advisor to political leaders in a number of countries, including the U.S., and as a financial regulator. In addition, I have been an entrepreneur and raised capital for several start-up companies, one of which, Sterling Semiconductor, was sold to a publicly-held company.

In my view, the Securities and Exchange Commission is in need of a drastic restructuring and downsizing, because it has done considerable damage to the U.S. economy:

- There were a total of 3,784 IPOs from 1980 to 1989, 5,598 IPOs from 1990 to 1999, and only 1,650 IPOs from 2000 to 2009. This drastic decline is in part explained by the additional regulatory burdens and costs the SEC has placed on those trying to go public. At the same time, foreign jurisdictions are gaining IPO market share. The number of IPOs is a rough proxy for the entrepreneurial climate in a country.

- The number of listed companies on major U.S. exchanges is a little more than half of what it was 15 years ago. The U.S. has also been losing global financial services' market share. Much of this decline is a direct result of the increasing cost of maintaining a public listed corporation and conducting financial businesses in the U.S.

- The U.S. share of world GDP has fallen from roughly a quarter a decade ago to less than one-fifth today. Part of the reason for the relative decline of the U.S. share is the excessive regulation U.S. companies are suffering, and some significant part of this unnecessary regulation comes from the SEC.

In the meantime, the SEC's budget has exploded, increasing an extraordinary five-fold in the past 15 years, with no objective indication that investors or financial markets are more protected or improved. Countries compete not only in the production of goods and services but also in regulatory efficiency, and by this measure the SEC should receive a failing grade.

In sum, the SEC has provided *negative* value added. If the SEC was a private company with this kind of track record, it would have long since gone out of business.

A major problem with the SEC is that it does not do proper cost-benefit analysis for both new and existing regulations. Many outside observers, who are familiar with what the SEC calls cost-benefit analysis, view it as joke in that it often is not up to professional standards. This is not surprising given the inherent conflict of interest within the SEC. Those who are hired to write regulations know that if they ever say they have written all of the regulations that really need to be written, they will no longer be needed; hence, no job.

The currency among those in government is not so much money as it is power, number of staff, and visibility. Thus, the people at the SEC, from the Chairman on down, have an incentive to grow the agency and get it into new areas – whether needed or not – in order to justify more staff and a bigger budget. There is an entire field in economics, known as "public choice," which is devoted to the study of the problem of those in government having different goals from those of the citizens they are supposed to be serving. The office responsible for doing cost-benefit analysis will not be considered a "team player" if it does approve most new regulations. A conflict of interest exists as long as those doing cost-benefit analysis report to those who have an interest in making the agency bigger. A partial solution to this problem is to make the office of the chief economist separate from the existing organization, much like the offices of the various "inspector generals" in government departments. One of the jobs of the office of the chief economist is to say "no," which requires independence.

In this testimony, I will give examples of the problems caused by inadequate cost-benefit analysis. I shall start with a personal example. I was one of the founders of a start-up semiconductor company. We grew rapidly, required more capital, and were faced with a choice of selling a major share of the company to a venture capital group, selling the company to a publicly-listed company, or doing an IPO. Our preferred solution was an IPO because we viewed that as the best alternative to maximize existing shareholders' value. However, once we had evaluated the cost of going public – much of it due to excessive SEC regulations – we had to settle for second best, which was a sale to a publicly-owned, listed company. This turned out to be an inferior solution that denied our initial investors much of the upside potential that they may have obtained with an IPO. SEC's overregulation did not protect our initial investors, but cost them dearly. Such overregulation, requiring excessive time by accountants, lawyers, and others, diverts needed capital away from new enterprises which have the most potential to create jobs and increase productivity.

Another example of SEC overreach is in the whole area of "accredited investors." The concept of the "accredited investor" was originally created as a "safe harbor" for those seeking investments in new or small enterprises, and not as a restriction on other perfectly suitable investors. The SEC took this constructive concept and turned it into a minimum requirement by making the registration process so expensive that small companies have almost no choice but to restrict themselves to only soliciting "accredited investors." By requiring minimum net worth and income standards for investors in start-ups, etc., the SEC now prohibits perfectly suitable potential investors from enjoying the profits of new and small companies. These standards appear to be totally arbitrary and rule out all but a couple of percentage of the entire population. Under the existing SEC definitions of an "accredited investor," a rock musician or football player with a high income and net worth but no knowledge about investments is "accredited."

On the other hand, a young professor of finance or tax lawyer who has not yet met the income and net worth requirements is not allowed to invest. This policy is "stupid," destructive, and discriminatory. Wealthy people are allowed to invest in things that can make them much more money, but poorer people (98%+ of the population) are prevented from the same opportunity.

The SEC's rationale for this destructive, discriminatory policy is to protect the less sophisticated investors from a potential loss. If it is really considered public policy to protect people from decisions causing financial loss, why does not government require everyone who gambles in Las Vegas, Atlantic City or wherever to become an "accredited gambler." When one studies the mathematics of probability, one learns that even in a fair game (with even odds) eventually it does not matter how much money a player has; he or she will lose it all; this is known as "the gambler's ruin theorem." Casino gambling is not a "fair game" in that the house must have its "take." It even gets worse with the state lotteries, which often give terrible odds (if they are not financial fraud, I don't know what is). Yet, anyone, no matter how poor or incompetent, is allowed, and often even encouraged by government, to gamble his or her entire net worth and then some.

Unlike gambling, including state lotteries, we know that most people who invest in the stock market make money over the long run. There are already plenty of statutes on the books to punish misrepresentation and fraud by stock promoters and boiler shop operators; and so the "accredited investor" concept is just not needed, and, in fact, it has now become destructive. It would be interesting to know how many people who were prohibited from investing in start-up companies instead gambled away part of the money. In sum, the SEC is engaged in an activity that reduces productive capital formation and denies most people the opportunity to improve their well being, which has the side effect of encouraging people to engage in irrational and destructive gambling. If the SEC had a serious and independent office for doing cost-benefit analysis, the existing "accredited investor" nonsense would have been deep-sixed many years ago. In a free society, people should be free to spend and invest their money as they see fit, and for the nannies at the SEC to pretend they know better is nothing more than what the great economist and Nobel laureate F. A. Hayek referred to as the "fatal conceit."

In has long been an article of faith at the SEC that trading on "inside information" is evil and must be stopped at all costs. This has led the SEC to create broader and broader definitions of both what is "inside information" and who is an "insider." The war on insider trading has much intuitive appeal; but like many things that seem obvious, it just does not stand up under rigorous analysis. The esteemed law and economics scholar Henry Manne wrote a classic book on the subject back in 1966 where he challenged the conventional wisdom on insider trading by observing that the attempts to stop insider trading had adverse effects on price discovery, thus disadvantaging investors who were not insiders. Over the years, more and more law and economics scholars have come to understand that Manne was correct. In recent years, Manne (who is dean emeritus of the George Mason University Law School) has continued to make his case, which is now increasingly obvious, of the almost impossibility of containing information in the age of instant information everywhere. To think that valuable information about relevant matters within a corporation is not going to leak out deliberately or accidently is the ultimate naivety. Here we have the SEC demanding that companies keep secrets from their investors and the outside world until the time when the SEC suddenly declares that now is the moment it can be released. Does this not contradict the self-proclaimed goals of openness and transparency?

The U.S. government cannot keep its most sensitive military and diplomatic secrets from leaking out, yet it expects thousand of companies with less sensitive information to keep it from leaking. Company officers and directors can be fined or go to jail for a mere momentary slip of the tongue or lapse in judgment. Yet, how often do we see high-level government officials go to jail or pay fines for far more serious breaches? Never!

The SEC continues to try to stretch the definition of an insider, even attempting to go after securities’ analysts whose job it is to ferret out information in order to serve investors. The Supreme Court in the Dirks case made it clear that, in the absence of a fiduciary duty to keep information secret, the law favors a free flow of information to the market. Yet, the SEC continues to ignore the Dirks case in its never-ending zeal to restrict free speech and legitimate information flow. The 1st Amendment’s protection of free speech should always trump demands by regulatory bureaucrats for more speech restrictions. This is particularly true since Manne and others have shown that the SEC’s information restrictions actually impede price discovery and hence deny investors the information they need to both protect and benefit themselves.

What is valuable to me as an investor is to know if the officers and directors of a company are buying or selling shares. With modern technology, this could be available to me within a few seconds of an “insider” buying or selling, allowing me to act on this information. Instant information on insider sale or purchases is likely to be much more useful to an investor than some long-held, sterilized press release overseen by those at the SEC about what they consider to be a change in the material condition of a firm. When I buy stock, I understand that those within the company are going to have more information than I do and will have an advantage over me – and that is the nature of life. To assume that a regulatory agency can somehow ensure that all investors have all of the relevant information, with the same level of understanding, at the same time is utopian non-sense and again evidence of the “fatal conceit.”

Trying to define an “insider” is an almost impossible task. During this past year, there were press stories about how a number of Senators appeared to have consistently made outside returns in their investment portfolios, and the implication was that they had information the rest of us did not have in making their investment decisions. I expect that was both true and not-illegal. Members of Congress make decisions all of the time that materially affect companies and, as a result, stock prices. An intention to place a costly regulation or tax on an industry or company, or give an industry or company a subsidy before it is announced to the public provides a perfect selling or buying opportunity for those members of Congress and their staffs in the know. There are many people in Washington who make their livings by trying to ferret out the intentions of the elected representatives.

As a result, there have been calls to place trading or other restrictions on members of Congress and their staffs. In my view, such restrictions would be largely unenforceable and counterproductive because there are too many ways to get around them; and with human nature being what it is, ways would be found to circumvent any restriction. Members could give a wink and a nod to key campaign contributors about intended actions to benefit or hurt particular companies. As a practical matter, it is not possible to prevent members of Congress, their staffs, their families, and their contributors, etc. from having prior information which will hurt or benefit companies. And having such prior information provides such an incentive to act upon it that some will. This may not necessarily be bad, because, to the extent such actions affect the stock price, non-inside investors will then obtain information that may influence their own buy and sell decisions.

If it is impossible to control what members of Congress will do or say, even though it may have a major impact on companies, why should only employees of companies and their relatives, friends, etc. be subject to insider trading restrictions? To penalize what should be the right of free speech by corporate executives, and not penalizing the similar speech of others in the know which may be even more damaging or beneficial to a corporation is both hypocritical and grossly unfair. There have been all too many cases of rouge prosecutors and regulators – some even from the SEC - making untrue charges (which were later thrown out of court) about companies and their executives that greatly and unfairly damaged investors. Corporate officers are subject to prosecution for making untruthful statements that hurt investors. Perhaps, investors who have suffered losses by untruthful statements or regulatory excesses by SEC personnel should be allowed to recover their losses from these miscreants in the same way that corporate executives are fined. This would encourage SEC personnel to be more responsible. The SEC and too many other agencies have abused the privilege of sovereign for far too long.

The SEC has almost completely ignored the arguments of many law and economics scholars in regard to insider trading. It has ignored the mile wide loop holes in its regulations, as noted above. It has failed to do adequate cost-benefit analysis. And it has failed to recognize the hypocrisies and practical unenforceability of its own rules in regard to insider-trading.

Again, public choice theory explains the behavior of the SEC in regard to insider trading regulations. If there are few restrictions, and if these restrictions are clear and enforceable, only a few people will be necessary to enforce them; hence, a smaller agency. Congress is going to have to force the SEC to make these necessary changes because the agency will never make them on its own because it does not think the changes are in its self-interest.

I have only touched on a few of the issues where the SEC needs to be radically restructured and downsized. The SEC has strayed far from its core mission, allowing Madoff, Enron, and others to completely elude the agency, while the SEC has chased never-ending new missions. The SEC does not need more staff and budget to do its job. The problem is that its staff and budget have grown so large and the agency is so-dysfunctional it is no longer doing its core job. The SEC has become a major drag on the economy by increasing uncertainty and risk for businesses, and by saddling businesses with costly and non-productive regulations.

The current budget crisis should be used as an opportunity to force the SEC to downsize and restructure. Companies that get into trouble are forced, at times, to lay off many of their staff in order to both survive and prosper.

Congress should say to the SEC:

> "You have failed to do adequate cost-benefit analysis so we will no longer give you the funds to enforce regulations that have not or do not pass a rigorous independent cost-benefit test. The overregulation has reduced productive capital inflow to the corporate sector, hurting productivity growth and job creation.
>
> You have in effect denied 98%+ of the population the opportunity to participate in new ventures without excessive cost. This has driven needed productive capital out of start-up companies. Thus, we will no longer fund the enforcement of the existing "accredited investor" restrictions. Investors will continue to be protected by laws and rules against misrepresentation and fraud.
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> Your insider-trading rules are inconsistent and in many ways destructive, so we will not provide you with the funds necessary to enforce these rules until you develop satisfactory alternatives, which are both economically sound and legally enforceable without trampling on basic Constitutional rights of the citizens."

Thank you very much.

Richard W. Rahn

Richard W. Rahn is a senior fellow of the Cato Institute and the Chairman of the Institute for Global Economic Growth. He is also a weekly economic columnist for The Washington Times, and serves on the editorial board of the Cayman Financial Review, and on the Governor of Virginia's Joint Advisory Board of Economists.

Dr Rahn served for two terms (2002-2008) as the first non-Caymanian member of the Board of Directors of the Cayman Islands Monetary Authority, which regulates the world's largest offshore financial center. In the 1980s, Dr. Rahn served as Vice President and Chief Economist of the Chamber of Commerce of the United States, Executive Vice President and Board member of the National Chamber Foundation, and as the editor-in-chief of the Journal of Economic Growth. Previously, he was the Executive Director of the American Council for Capital Formation. In 1990-1991, he served as the U.S. co-chairman of the Bulgarian Economic Growth and Transition Project. In 1982, President Reagan appointed Dr. Rahn as a member of the Quadrennial Social Security Advisory Council. During the 1988 Presidential campaign, he served as an economic advisor to President G.H.W. Bush.

In 1990, Dr. Rahn founded the Novecon companies, which included Sterling Semiconductor (now owned by Dow Corning). He continues to serve on boards of private companies.

Professor Rahn has taught at Florida State, George Mason, George Washington, and Rutgers Universities; and at the Polytechnic University of New York, where he served as head of the graduate Department of Management. He also was an instructor for the U.S. Air Force and the Washington economic advisor for New York Mercantile Exchange.

Dr. Rahn is a member of the Mont Pelerin Society. He serves as a member of the Board of: the American Council for Capital Formation, the Small Business & Entrepreneurship Council, and the Institute for Research on the Economics of Taxation and as a member of the Board of Visitors of the Pepperdine University School of Public Policy.

Dr. Rahn has written hundreds of articles for newspapers and magazines such as the Wall Street Journal, The New York Times, USA Today, The American Spectator, The Weekly Standard, National Review, and The National Interest. He has contributed to numerous books and professional journals and is the author of the book The End of Money and the Struggle for Financial Privacy (1999). As an economic commentator, he has appeared on such programs as the Today Show, Good Morning America, Kudlow and Co., Wall Street Week, MacNeil-Lehrer Newshour and Crossfire, and was a weekly commentator for Radio America. He has testified before the U.S. Congress on economic issues more than seventy-five times.

Dr. Rahn earned: a B.A. in economics at the University of South Florida, from which he received the "Distinguished Alumnus Award," an M.B.A. from Florida State University, a Ph.D. from Columbia University, and was awarded an honorary Doctor of Laws by Pepperdine University.

December 2, 2010

Committee on Oversight and Government Reform
Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)(5)

Name: *RICHARD W. RAHN, Ph.D.*

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1. Please list any federal grants or contracts (including subgrants or subcontracts) you have received since October 1, 2008. Include the source and amount of each grant or contract.

   None.

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2. Please list any entity you are testifying on behalf of and briefly describe your relationship with these entities.

   None. I am testifying as a private scholar.

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3. Please list any federal grants or contracts (including subgrants and subcontracts) received since October 1, 2008, by the entity(ies) you listed above. Include the source and amount of each grant or contract.

   None.

I certify that the above information is true and correct.

Signature: Date: *May 5, 2011*