Overgrown Wall Street regulation needs a trim in 2017

Thaya Brook Knight

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Well-functioning capital markets are the lifeblood of progress; without capital, companies cannot develop new communication technologies, safer cars, better pharmaceuticals, or any of the things that make modern life as comfortable and safe as it is.

While markets need rules of the road to facilitate trading, these rules don't have to be government-created, and they certainly don't need to be as lengthy and complex as they are. It's time to reevaluate the existing laws and rip out the overgrowth.

Effective capital market regulation does three things: (1) creates rules of the road for exchanges (although exchanges can do this themselves); (2) deters and punishes fraud; and (3) facilitates price discovery.

It does not punish small family businesses. It does not protect investors from stupid decisions. It certainly does not promote social causes. Current government regulation attempts to do all of these things, but it does each of them poorly and imposes needless costs on the system as a whole.

One of the most confounding things about securities regulation is how difficult it can be for a company to know it's even selling securities. Take a young chef starting a new restaurant. If this chef asks a few friends to "go in on" her new business and offers to share the profits with them, does she know she's probably conducting an illegal securities offering? Probably not.

These types of informal securities offerings happen all the time. When a regulation is routinely broken, with no discernable harm, that regulation is probably a bad one.

Attempts at investor protection fare no better under existing law. To the extent that investor protection is a legitimate goal of securities regulation, its focus should be on deterring fraud and facilitating disclosure, not preventing a bad investment, but current regulations go much further than this.

For example, average investors are legally barred from buying some of the most attractive stocks because of rules that restrict investment to only individuals who are rich. It’s as though Neiman Marcus was required by law to lock its doors against anyone earning less than $200,000 a year, even if shoppers had money to buy and Neiman wanted to sell.

The rationale behind this restriction is that people of average means are less able to understand sophisticated investments than their richer compatriots, and are less able to withstand financial loss. The consequence is that those everyday investors are kept out of the upside benefits too. Now, nothing about being a publicly traded company makes it immune from ruin, or from being a poor investment.

If the dot.com bubble of the 1990s taught us anything, it’s that an initial public offering (IPO) doesn’t protect a company from going down or from taking its investors down, too. But even if public companies weren’t the best investment, it is not the government’s place to restrict people from doing dumb things with their money. I may want to spend $2,000 on a designer handbag; should the government tell me I can’t even if I have the money in the bank?

Regulations aimed at social causes may be the most harmful, not only because they manipulate the securities laws into doing something entirely outside of their intended use, but because they require financial regulators to wade into unfamiliar territory, with often disastrous results.

Under one Dodd-Frank rule, for example, public companies must disclose the supply chain for certain minerals. Its stated purpose is to alleviate the humanitarian crisis in the Democratic Republic of the Congo by limiting the funds available to war lords.

But instead of reducing warfare, the rule may have instead reduced investment in a developing country desperate for growth, as companies have steered clear of the region for fear of making inaccurate disclosures about the supply chain.

The SEC recently began a review of this rule, hopefully leading to its repeal, but the only way to prevent future misguided rulemaking is for lawmakers to refrain from shoehorning social causes (admirable though they may be) into entirely unsuitable regulatory regimes.

If federal securities regulation exists, it should be carefully cabined to ensure that it hews to the three principles outlined above. Dodd-Frank added 2,300 pages and more than 22,000 pages of regulations (and counting) to an already overgrown area of federal regulation. It’s time for the pruning shears.

Thaya Brook Knight is associate director of financial regulation studies at the Cato Institute. She is an attorney with extensive experience in securities regulation, small business capital access, and capital markets.