

March 7, 1995

Commissioner Steven M. H. Wallman
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

*Re: The Advisory Committee on the
Capital Formation and Regulatory Processes*

Dear Steve:

Yesterday's meeting was stimulating and enjoyable. It led me to summarize the following thoughts.

General Perspective

Today's securities system, while a model for the world, nevertheless dates in many particulars from the 1930s. Today's investment world differs in many ways. To mention a few...

- *Institutional investors* now hold about 50 percent of U.S. debt and equity securities (and the demographics of our population imply that this percentage will continue to rise for the next several decades).
- *Modern investment theory* provides new insights on investment strategy, portfolio management, asset allocation models, etc.
- *Modern game theory* (including experimental economics) tells much about the behavior of individuals in cooperative and noncooperative games and can help realign the rules of a game to assure desirable outcomes. (The question we were discussing at the first meeting as to whether private securities issues should be disclosed to the market before or after they take place could be analyzed under this research paradigm.)
- *Information technology* has at least three pertinent effects. First, it permits the ever-faster design and marketing of innovative financial instruments that can be used to reallocate, and manage the risk of, financial claims. Second, it makes the markets potentially more transparent than ever (as investors get onto the information highway). And third, it radically accelerates the pace at which companies change, making quarterly historical snapshots increasingly irrelevant to assessing their status and prospects.
- *Globalization* of capital markets means that U.S. investors and investees are both competing internationally. (Some of these effects are direct (as when a U.S. investor purchases securities of an overseas company), and some are indirect (as when agents create synthetic securi-

ties that have the effect of international transactions, in some cases circumventing laws in either or both countries involved.)

- A burgeoning trend toward *privatization* affects government at all levels. Many functions are more efficiently performed under the market disciplines of the private sector. Even such inherently governmental functions as law enforcement, dispute resolution, and prisons are being privatized. Of course, some aspects of securities regulation are already privatized (e.g., through the national stock exchanges).
- The evidence developed by Michael Porter (in *Capital Choices*) suggests flaws in U.S. capital flows. He asserts that dysfunctional accounting and disclosure policies cause misdirected capital among companies and within companies (resulting in a preference for investment in hard capital vs. soft capital). (Hard capital includes factories and machinery. Soft capital includes research and development, human resources, customer and vendor relations, software, etc.) He also asserts that flaws in the securities laws create a bias toward uncommitted (read "short-term oriented") investors, pressuring managements to focus unduly on short-term results.

It is doubtful that a system of securities regulation developed from scratch in this environment would be identical to the one that has evolved from the 1930s. Since the effectiveness with which capital is raised and deployed is a matter of national interest (and competitiveness), how the securities regulation system serves its purposes is certainly a worthy object of study.

Data

In order that the committee be able to assess the current system and its progress, it needs certain economic data. Some may be impossible or too expensive to obtain, but there may be useful surrogates available. Specifically, it would be interesting to see quantitative information such as the following (all in longitudinal form over, say, a 10- to 15-year period):

- Total U.S. business capital, partitioned between public (i.e., SEC registered) and private capital.
- Total annual U.S. new debt and equity capital formation (other than retained earnings), partitioned between public and private.
- Total (and per transaction) annual transaction costs for issuing new securities (public vs. private).
- Total (and per registrant) annual costs for maintaining public capital ('34 Act companies).
- Annual indicators (e.g., fraud cost, prosecution/defense costs, frequency of allegations, frequency of enforcement actions) of fraud costs to investors (including "false alarms").
- Total annual "income" accrued on behalf of absentee owners and creditors (net income plus interest costs for all non-owner-managed-for-profit companies plus all interest costs for not-for-profit and governmental entities).

- Total annual costs of accumulating, deploying, managing, and recovering capital (total revenues of underwriters, investment bankers, securities brokers, securities attorneys, auditors, mutual fund management companies, trust companies, money managers, and financial printers plus total investment/credit related costs of banks, insurance companies, and pension funds plus the total costs of the SEC and the state securities agencies plus the total compliance costs of capital users). The ratio of this total to the total in the preceding bullet would be the "drag" in putting the wealth of individuals to work in productive enterprises.
- Total litigation costs under '33 and '34 Acts (attorneys' fees of plaintiffs and defendants, fines, judgments, and settlements).

For the last six bullets, it would be useful to have comparative data from other countries with developed securities markets as well.

I hope these thoughts are useful, and I look forward to the committee's further deliberations.

Best personal regards.

Sincerely,



Robert K. Elliott