Local Stock Exchanges and National Stimulus

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Since the global financial system unraveled in 2008, U.S. policymakers have struggled heroically to improve the performance and oversight of global banks and investment firms. But these actions have been largely unresponsive to the growing number of Americans who would like to remove their hard-earned retirement savings from these high financial fliers altogether and invest their nest eggs instead in their community. Might it be time for policymakers to consider the potential stimulus payoffs from nurturing micro-equity investments?

One reason for growing public interest in local investment is the spread of "buy local" campaigns, a movement that is more than just local hucksterism. Consider the title of an article in a recent issue of *Time*: "Buying Local: How It Boosts the Economy." Cutting-edge economic developers (except at the national level) increasingly recognize the importance of strengthening locally owned, small businesses.

Growing evidence suggests that every dollar spent at a locally owned business generates two to four times more economic benefit–measured in income, wealth, jobs, and tax revenue–than a dollar spent at a globally owned business. That is because locally owned businesses spend much more of their money locally and thereby pump up the so-called economic multiplier. Other studies suggest that local businesses are critical to tourism, walkable communities, entrepreneurship, social equality, civil society, charitable giving, revitalized downtowns, and even political participation.

Despite this overwhelming body of evidence, the national stimulus efforts have proceeded with no specific attention to local businesses. Yet even some very simple reforms that opened up local businesses to local investors could make a huge difference.

Consider two anomalies of the current financial system (even if the latest reforms work exactly as planned). The first is that locally owned, small businesses constitute about one-half of the private economy in terms of output and jobs, but they receive almost no investment from the nation's pension funds or from mutual, hedge, venture, or any other kind of investment funds. In a well-functioning financial system, roughly one-half of the investment should go to roughly one-half of the economy. Today, every American, even the stalwart advocate of community development, is overinvesting in the Fortune 500 companies and underinvesting in local businesses key to local vitality. This is a colossal market failure.

Does this occur because local businesses are less profitable than global ones? Hardly. According to the Statistical Abstract, sole proprietorships (the legal structure chosen by most first-stage small businesses) are nearly three times more profitable than C-corporations (the structure of choice for global businesses).

Moreover, several global economic trends are now making U.S. local businesses increasingly competitive. Rising energy prices make local production for local consumption more competitive against Wal-Mart production in China. The falling dollar revitalizes U.S. manufacturers. As Americans shift their spending from goods to services, a trend that has been occurring for 50 years, local businesses will see more competitive opportunities still, given that most services depend on direct, personal, and ultimately local relationships.

A more plausible explanation for the absence of local business investment is the paucity of market-clearing mechanisms, essentially local stock exchanges, that would allow local investors to find, buy, and sell local securities. Interestingly, smaller stock exchanges, primarily facilitating intrastate transactions, were quite common until the securities reform acts of the New Deal era. Some were poorly designed and fraught with fraud and inefficiency, but others were reasonably successful. Once the national exchanges became reliable and widespread, however, businesses and traders alike gravitated away from the state exchanges. Today, only a half dozen public exchanges still operate in the United States.

Given the fact that market-clearing mechanisms exists on a limited scale, one must ask why local businesses do not use them. Without sacrificing their local character, for example, local businesses could issue nonvoting preferred shares of stock for national investors and trade them over the counter on existing exchanges. There is certainly no technical reason this could not be done. Prosper.com and Kiva.org have demonstrated how small businesses seeking microloans can be vetted, listed, and exchanged efficiently.

The real reason small public offerings and local stock exchanges do not flourish today is that the Securities and Exchange Commission (SEC) has essentially banned them. Existing laws place huge restrictions on the investment choices of small, "unaccredited" investors–a category in SEC vernacular that includes all but the richest two percent of Americans. The regulations prohibit the average American from investing in any small business, unless the firm is willing to spend $50,000 to $100,000 on lawyers to prepare a private placement memorandum or public offering–thick documents with microscopic, ALL CAPS PRINT that no human being has ever been observed actually reading.

Which brings us to the second anomaly of today's financial system. Suppose you wished to play blackjack in one of the more than one thousand casinos operating across the United States. Do you first have to prove that you're an accredited gambler? Must you read a thick disclosure statement letting you know the risks of blackjack before you place your first bet? Everyone understands that these would be silly requirements.

We have two fundamentally contradictory legal regimes operating today. One, called gambling, allows every adult, irrespective of income, to risk everything for a probable loss. Another, called small-stock investing, prohibits 98 percent of us from investing in the local businesses that are essential for the well-being of community, unless businesses pay prohibitively expensive lawyers' fees to prepare the unreadable disclosure statements.

Something is deeply wrong here. Outdated federal securities laws have left Main Street dangerously dependent on Wall Street, and overhauling them may well be a key to economic revitalization.

The good news is the local businesses could get a huge investment boost with some modest securities reforms that would cost little or nothing. One easy reform would be for the SEC to exempt from its usual expensive disclosure requirements any low-risk public ownership of locally owned microbusinesses. By low-risk, I mean that no person can hold more than $100 worth of any one stock–which means that we're freeing up people to engage in the risk equivalent of a nice dinner for two. By local ownership, I mean that only residents within a state can buy, hold, and sell stock shares. And by microbusinesses, I mean any business with a total stock valuation on issuance of less than $250,000.

A related reform would be for the SEC to set simple rules for the setting up of internet platforms for trading the exempt securities above. The few remaining national players, such as the New York Stock Exchange and the NASDAQ, have enough authority now to launch a product that would enable states, regions, or municipalities to set up trading portals. But because they do not see large profit opportunities–a mistaken judgment, in my view–it will probably fall to new entrepreneurs, such as Mission Markets, to redesign local exchanges for smaller, slower transactions. The SEC should streamline its regulations to enable more such exchanges to get off the ground at an affordable regulatory price.

Here are a few other legal reforms that would be helpful:

- Micro-investment funds. Let's allow small investors to pool their money in backyard investment funds (again, up to $100 per person) that in turn invest in diverse portfolios of local stocks. (Only the super rich can invest in such funds now.)
- Co-op investment funds. Let's allow cooperatives, most of which are owned by workers or consumers living in a single community, to set up investment funds empowered to make local investments on behalf of their members. (Currently, they can only invest members' capital in businesses owned and run by the co-op itself.)
- Pension fund participation. Let's allow any pension fund that places as much as 5 percent in local securities, either directly or through microbusiness investment funds, to meet legal standards of "fiduciary responsibility." (Current regulations define the term in a way that directs virtually all such investments must go to global companies.)

New community-based funds, securities, and exchanges, of course, still need oversight to prevent fraud and ensure accountability. However, given that nearly all local investment is, by definition, intrastate, these new rules could be left to the existing securities departments in the 50 states. Once state-level laws are put into practice, many of the absurd requirements of the SEC expensive audits and lengthy legal filings might finally disappear.

Were these reforms enacted nationally, literally trillions of investment dollars could begin to move into the local business economy. Entrepreneurs, hungry for new capital in the post-meltdown credit crunch, would begin to restructure their businesses to receive microcapital. Investors terrified about betting all their money in the global firms with a checkered past would start shifting their investments to local businesses they know, trust, and can visit and "ground-truth" with tough questions. The result will be a nation of stronger local economies, with American investors increasingly placing more of their money into backyard businesses.

Two final points about these ideas. First, the experimentation opened up at the state level will invite other grassroots engagement, invention, and competition that will help demonstrate the viability of simpler, cheaper, more transparent investment regulatory frameworks. Second, and most significantly, all these regulatory reforms will cost almost nothing. Instead of spending billions more in federal taxpayer dollars to prop up dubious big financial institutions, why not create for free a system that is more stable, safe, lucrative, and democratic?

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