April 18, 2011

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Hawaii State Legislature
Senate Committee on Commerce and Consumer Protection
The Honourable Rosalyn Baker, Chair
The Honourable Brian Taniguchi, Vice -Chair
415 S Beretania St # 317
Honolulu, HI 96813-2407

RE: SCR 134--REQUESTING THE CONVENING OF A WORKING GROUP TO INVESTIGATE THE CREATION OF A LOCALLY-FOCUSED, HAWAII-BASED STOCK EXCHANGE

Dear Ladies and Gentlemen of the Committee:

My name is W. Trexler Proffitt Jr. and I am a professor or organization studies at Franklin & Marshall College in Lancaster, Pennsylvania. There are only a very few scholars across all areas of economics, business, and history who have examined the issues surrounding local or regional exchanges and it is my pleasure to be one of them. It is one of my particular focus areas with my students since 2007.

I am writing today in support of S.C.R. 134. In previous testimony, I addressed the feasibility of local exchanges. Today I would like to address one aspect of the exchange proposal that I have studied with great interest—the demise of previous local and regional exchanges in U.S. history and the relevance of that history to the proposed exchange being considered here today. It would be a good idea to create exchanges in Hawaii or elsewhere only if we were sure that they would be able to do their job well. Past failures of regional exchanges should give us some pause.

After doing research on it, I've come to my conclusion already—it can be done well if done right. In 2010, we completed historical research on the economic history of local exchanges on local economies, and the history of U.S. regional exchanges. At this time, I am actively working to create a local exchange in my region (provisionally called LanX: Lancaster Sustainable Enterprise Securities Exchange) and to create a nonprofit educational association to help start and support exchanges where appropriate in the U.S. and Canada (provisionally called Focus

Local Finance Coalition). In fact, you may notice testimony from my collaborators at SVX in Toronto and in Hawaii—I want to be clear that I am collaborating with them up front so that you can see my enthusiasm is transparent. The data have convinced me. I want to play a constructive role in helping well-conceived local exchanges succeed. I feel the Hawaii initiative is a step in the right direction.

To summarize the argument I would like to present to you, consider the following assertions that I believe are well documented in our work and in the few other scholarly papers on this topic.

1. Local Exchanges were Normal and Useful for Decades
2. Technology Decreased the Need for Local Exchanges circa 1900
3. Local Exchanges Failed to Adapt to Change
4. New York Won but Chose to Focus on Large Firms
5. The Internet 2010 has Changed Everything Again
6. New Exchange Models can Help Smaller Businesses

In the next section, I intend to flesh out this sequence so you have some sense of what underlies each point.

1. In the 19th century, civic leaders in U.S. cities started local exchanges in order to assist with regional economic development. There were quite a few of these: at least 30 were created between 1790 and 1930. In addition to the more familiar New York, Boston, and Philadelphia exchanges, the list includes Baltimore, Milwaukee, Detroit, Washington, DC, Pittsburgh, St. Louis, Chicago, Spokane, Denver, New Orleans, and Honolulu. Along with complementary institutional infrastructure, local exchanges allowed entrepreneurs to obtain investment to finance capital-intensive activities like mining, manufacturing, banking, and transportation in what were mostly rural economies. The economic literature on this topic suggests that in general, countries, cities and regions that receive a securities exchange (ie. capital market development) generally have subsequent positive economic growth. Well-functioning capital markets add jobs and facilitate economic investment, which manifests itself in the founding and growth of local small business and working capital for larger, growing businesses. For the 30 regional U.S. exchanges, the average impact on jobs growth was about 100%. To translate, an exchange roughly doubles a region's growth rate.

2. By around 1930, it was clear that communication technology (telephone and telegraph) had transformed place-based investing into a national market. Despite the existence of many regional exchanges, the eventual widespread adoption of new communication technology allowed firms and investors to use any exchange to make transactions, independent of their geography. While it is more efficient for any single security to be listed on one exchange instead of many, it is not necessarily the case that all exchanges would lose out. But because of various factors associated with concentration of

investment resources and political clout, most transaction participants favored New York if given the choice. Over time, transaction volume moved to the New York markets, making regional exchanges obsolete by about mid-century. Some hung on longer, but it was a downhill slide. Philadelphia, the first securities exchange in the country, was also the last acquired by New York. Nasdaq OMX acquired it in 2007.

3. Why couldn't regional exchanges keep volume local and stay alive? Regional exchanges failed to adapt to the new circumstances in several ways. First, their revenue models were all based on the idea of charging fees for transactions. As volume moved away, they desperately increased transaction fees, or cut costs, pricing themselves out of the market or providing worse service. A second fatal decision by regionals was their insistence on keeping the "big fish" through dual-listing. The pride of listing a famous national company on a local exchange meant that they were competing directly with New York for listing business among the largest firms. It is not a good idea to go head to head with a larger, wealthier competitor, and New York has always been larger and wealthier. For a few decades, consolidation among the regionals helped offset the move to New York, but there too, the slide continued. This leads to the third problem: regionals stopped developing new business. Because they were so focused on existing listings instead of new listings, and lost their sense of place, they did not replace departures effectively with new local firms. In the end, New York won the fight for national listings.

4. After business began consolidating and then migrating to New York, several interesting things happened. First, New York exchanges like NYSE and Nasdaq began to focus on the larger end of the market. These days, neither exchange much wants to list securities valued below $100 million. There simply won't be enough volume (ie. fees) to justify it. Second, New York exchanges began to focus their revenue model less on general transactions and more on services and specialty trading. There is no money any longer, to them, in regular securities trading.

5. The internet has changed the way securities trade forever. The new capabilities of online trading platforms have made obsolete older open outcry floor systems. All major exchanges today are virtual or getting there quickly, cutting expenses dramatically. Today, we have off-the-shelf technology that was novel even 5 years ago and the pace of cost reduction and increasing reliability is only accelerating. Transaction fees on trades have been declining for 15 years because of the greater adoption of internet platforms. And new forms of account management and record-keeping mean fewer people can oversee vastly more transactions than ever before. This has several implications. First, it is no longer possible for an exchange to make money by charging high fees for simple transactions. Second, it is worth noting that this technological shift came too late to save regional exchanges.

Most were out of business decades before the advent of the internet. Last, even those local exchanges that were around suffered from the same mental model of dual-listing large issues, not developing new business, and were acquired.

6. Small businesses need capital and cannot usually access national markets. T New, targeted local exchange models can fill this equity funding gap for businesses well under the $100 million capitalization level. In fact, there is so much business to be had under the $10 million level that smaller local exchanges can play a "farm team" role to New York. If a local business grows to attain national scale, it will have a much easier time listing in New York because it operated in the local market—complying with listing rules, generating compliant reporting, disclosing news, investor relations—all of these activities will be easier. While many businesses will stay below the threshold for this transition, a local system is completely complementary and non-overlapping with the national system. There are some important lessons, though, that need to be taken into account.

Implications of History for a Local Exchange

Lesson 1: Don't Chase Big Fish
The next wave of local exchanges should not compete with New York. All business above the $100 million capitalization level should be left to the big leagues. Instead, local exchanges should stick to their knitting and emphasize the latent and surprising value that is sure to abound in their local communities. This is where they can have local impact and stay away from business that truly is national. As a practical matter, this means attending to businesses with sales of $25 million or less per year and securities issues in the neighborhood of $500,000 to $5 million.

Lesson 2: Make Listing Valuable, but Avoid Charging for Transactions
Local exchanges of the future need to operate with modest profit expectations, drawing fees mostly from listing and not from transaction fees. Firms and investors should pay to be associated with the local exchanges, but be able to transact with relative ease. What will exchanges do? A huge function that is very important but taken for granted are the governance and transparency imperatives of exchanges. Exchanges provide a way for investors to obtain standardized, compliant data on local firms, ranging from financials to material news. This provides an important quality check on firms that otherwise might appear risky to investors. Their initial listing process, and the efforts firms make to remain listed, help to dramatically reduce transaction costs to investors. In addition, a regular site for detailed reporting draws investors to the same spot to review many listings, creating a virtual community interested in local firms.

Lesson 3: Develop New Business

Local exchanges of the future must always be developing new business. This means intensive search and client engagement in the community to offer interesting methods of securitization to local community businesses.

Let's return to Hawaii. I must admit I don't know much about the Honolulu Stock Exchange. I have not successfully located its archives. But using the general findings, we can see why the Honolulu Stock Exchange (circa 1902 to 1977) had no chance for long-term success. It was started just as the telephone and telegraph were becoming common, and once trans-Pacific communication came to Hawaii, its days were numbered. By the same token, it did not survive long enough to enjoy the amazing cost reductions and capabilities associated with the internet. These are only a few years old now. In 1977, things must have looked quite hopeless. On the other hand, for some of the 75-year history, the Honolulu exchange must have had a positive impact on Hawaii businesses. It is not necessary that an exchange produce benefits forever for it to still be a good idea for 20 or 30 years.

The Hawaii Local Stock Exchange proposal is different in many ways. First, it maintains focus on Hawaii. There is enough business in Hawaii in the target niche to keep a small staff busy for many years. Second, it can utilize technology to remain affordable and ultra-local in ways that eluded the ancestral Honolulu exchange. Last, it can help Hawaii economic development by constantly seeking new listings—encouraging and supporting firms who wish to share their fortunes with a motivated and partisan Hawaii public. In general, a new local exchange, properly focused on developing small and medium size businesses, should provide economic development benefits for at least several decades.

The proposed working group does not create a local exchange. Instead, it addresses the impediment of regulatory uncertainty that remains the foremost concern of firm owners and investors alike. For 75 years, Hawaii allowed a local exchange to exist. The proposal to return to the best of that tradition, coupled with a desire to avoid any pitfalls, will result in new investment money and jobs creation for the state. It is quite essential that this niche space below $25 million in capitalization attain a regulatory home that is both respectful and thoughtful of the rules that govern the big exchanges and large firms, but also imposes relatively lower costs on in-state small and medium firms and in-state exchanges. This is where I think a working group is a fantastic solution and I support its creation wholeheartedly. Please let me know if I can help.

Sincerely,

W. Trexler Proffitt Jr.