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State of Hawaii Senate
Testimony in Support of S.C.R. 134

From

W. Trexler Proffitt Jr.
Assistant Professor of Organization Studies
Business, Organizations, and Society
Franklin & Marshall College
PO Box 3003
Lancaster PA 17604
email: trexler.proffitt@fandm.edu
phone: 717-291-3990
fax: 717-358-4568

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. My scholarly credentials in this area qualify me as an expert witness to comment on the establishment of a working group to investigate the desirability of a local exchange within the State of Hawaii. I am writing today in support of S.C.R. 134. Because I am sure you will receive much good background information about local economic development and the importance of small business and small business financing from other sources, I would like to share with you the results of my research on local exchanges.

The founding of local exchanges today is more a matter of desirability than feasibility. Local securities markets are more feasible than they have ever been in recent memory. The issue for policy is whether they are desirable from an economic policy point of view, not whether they are feasible.

I would like to share with you the findings of my feasibility analysis research in the area local securities exchanges. In 2008 I received a grant to produce a feasibility study for a local securities exchange concept from economic agencies associated with the Pennsylvania state government. My collaborating partner has been a local business association, the Susquehanna Sustainable Business Network. In addition, in 2009, I studied a newly founded exchange called InvestBX in the large city of Birmingham, United Kingdom. In 2010, I completed historical research on the economic findings around the impact of exchanges on local economies, and the history of U.S. 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).

The 2008 study was the first-ever state-funded feasibility research about U.S. local exchanges. I used my local eight-county home region of South Central Pennsylvania as a prototype. This region has about 2.5 million people and more than $65 billion in GDP. It is centered around four class 3 cities: York, Lancaster, Reading, and Harrisburg.

The conclusions were straightforward: local exchanges, done well, are quite feasible, efficient, and potentially provide great local benefit. They can operate on a relatively modest budget to facilitate financing for small and medium businesses in a way that is complementary to and synergistic with other financing mechanisms.

In addition, local exchanges promise to produce more bang for the buck. They are an efficient capital allocation method that yields more quality jobs growth and other desirable economic development outcomes per dollar spent than either direct government investment (such as Federal stimulus) or less direct forms of government finance (such as SBA loans). The order of magnitude of this improvement is dramatic: the cost of one job created by using a local exchange will average $10,000 per job in administrative expense. The recent Federal stimulus produced jobs at a rate of $90,000 per job in administrative expense, according to the Office of Management and Budget. In comparison, local exchanges are cheap! Plus, with a local exchange, the private sector is the primary sector to bear these administrative costs, not the taxpayer.

I would like to share with you some of the research that undergirds this optimistic conclusion. One question was whether the benefits of a local exchange would be significant. The economic literature on this topic suggests that in general, countries, cities and regions that receive a securities exchange (also termed capital market development) generally have subsequent positive economic growth. In other words, the consensus view is that well-functioning capital markets add jobs and facilitate economic investment, which is going to manifest itself in the founding and growth of local small business and working capital for larger, growing businesses.

It is also U.S. policy to encourage capital market development, just in other countries. Since 1945, U.S. foreign policy and international development policy (exemplified by the World Bank and International Monetary Fund) have encouraged (i.e. paid for) the founding of securities exchanges abroad to facilitate economic development in emerging markets. Therefore, the idea that exchanges help with economic development is taken as an article of faith by the U.S. government and the developed world. The academic literature merely confirms this assumption, with the caveat that it is done well and where appropriate.

In addition, I began to survey the history of stock exchanges in U.S. history and was surprised to discover that many cities (and the regions around them) benefited in the past from the establishment of local exchanges for decades after these exchanges were founded. In fact, Hawaii had a local exchange called the Honolulu

Stock Exchange between roughly 1900 and 1972. Although I have not done a case study on that exchange, it would be interesting to do so in the future. Our historical research uncovered no fewer than 36 distinct securities exchanges founded in the United States between 1790 and 1930. 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.

But there was also an interesting puzzle. Beginning in the 1930s, when the Federal Securities and Exchange Commission began regulating exchanges, the dozens of local exchanges around the country began to disappear through consolidation or discontinuation. This consolidation accelerated by mid-20th century to the point that there really are only two exchange operators in the United States today: the New York Stock Exchange and Nasdaq. The next research question then quite logically was whether new exchanges founded in 2011 or later would be desirable given this failure in the past.

On this question, I endeavored to understand the reasons why prior exchanges faltered and whether new ones would suffer the same fate. After all, we would not wish to recreate a poor system that had already self-destructed. Luckily, there are enough differences between the conditions that contributed to the demise of most of the early era local exchanges and the conditions that favor the founding of new ones today. In particular, I would call attention to technology, globalization, and consolidation. I will discuss these in turn.

1. Traditional Tools Updated with Modern Technology

Early exchanges became redundant because of technology but that trend cuts both ways. Beginning in the late 19th century, trades in St. Louis or Pittsburgh could be done in New York as well with the advent of the telegraph and telephone. In addition, local exchanges competed quite directly with New York exchanges to list the securities of the largest and most widely-held corporations. Accordingly, direct competition for the same “big fish” led to a price war and New York won it. By 1950, it was clear that any company that wanted to raise capital should do so on Wall Street, not Main Street.

But times have changed once again. The internet technology available today has democratized the process of listing and trading securities once again, opening up new niches. It is once again because of technology possible to take listing and trading out of Wall Street and to relocalize it in areas that need more responsive local financial institutions. An exchange can now operate in a relatively low cost virtual space that is basically off-the-shelf. This was not true ten or even five years ago but has made exchanges very low cost to create today.

2. Globalization and Relocalization

As capital markets have become detached from place and people, there is a new trend towards reconnecting with the local economy and reacquiring community and community values. People are starting to realize a balance between global

connections and local community is highly desirable. This suggests that there is today stronger demand than ever for increased local investment alternatives, coupled with a willingness on the part of investors to prioritize investing locally as one of their core investment objectives. In our work with local investors, we have found a strong craving for local investments suggesting that there may be significant demand for such opportunities. This trend might not have been apparent in the past but the recent financial crisis has focused new light on the possibilities.

Consolidation and Niche Space

With the consolidation of the many local exchanges of the past into just two major exchange organizations today, a niche space has arisen in the "equity gap" that affects small and medium businesses. This equity gap is created by the larger national exchanges by their preference for listing only larger firms. Smaller firms have much less access to the same sorts of financing as Wal-Mart or Starbucks, in part because the large exchanges really would prefer not to deal with firms with capitalization lower than $100 million. The presence of this niche suggests that small and medium firms up to that level would benefit from more local financing options. In particular, firms that were able to connect meaningfully to their local community would have the best chance of being valued correctly.

It seems safe to say that new local exchanges can serve a wide market niche up to about $25 million in market capitalization with no direct competition with national exchanges. This is important because local exchanges then perform a "farm team" role of validating and supporting small and medium firm growth, such that firms might eventually migrate to the national exchanges later on. So long as new small and medium firms keep entering the exchange locally, graduation to the "big leagues" is not a threat at all. National exchanges can keep doing what they are doing, and they will get a new source of growing firms coming from the farm teams around the country.

In addition, it is important to understand that local exchanges do not have to operate the way the big exchanges do, or past exchanges did. In our work, we have calculated that an exchange that attempts to list local securities issues ranging in value from $500,000 to $5 million will be able to support itself primarily with very reasonable listing fees paid by the firm issuing securities. Consider this scenario: if the exchange can list at least five local firms per year, averaging $2 million per issue, producing fees averaging $150,000 per listing, then this produces $750,000 per year, the amount it would cost to operate the exchange. While the scenario can be adapted to any local market with different expectations, we find this a reassuring and reasonable budget to consider.

So what is left to prevent local exchanges from popping up all over? Regulatory uncertainty remains the foremost concern of firm owners and investors alike. This is where a working group can add the most value. 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.