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Richard A. Epstein

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THE DANGERS OF “INVESTOR PROTECTION” IN SECURITIES MARKETS

RICHARD A. EPSTEIN*

I. INTRODUCTION: TROUBLESOME TIMES

The purpose of this short Article is to step back a bit from the current controversies to ask this question: What is the proper way to understand the impact of domestic regulation on international securities markets? Any proper analysis has to call into question the basic structure of securities regulation. It must also deal with recent innovations such as Sarbanes-Oxley.¹

This analysis does not take place in a vacuum. It is instead yet another act in the long-term clash between two worldviews. The first is that of individuals who hold a general classical liberal orientation. That approach sets its initial presumption to fear, not welcome, government regulation of financial markets on the simple ground that private incentives for profit and gain will do a better job of ferreting out fraud and other forms of misconduct than schemes of government regulation that require expensive standard measures—e.g. registration statements—to supply prophylactic responses to fraud. On the other side of this divide lie individuals who think that actors in private markets are much more limited in their ability to detect and to contain fraud. On this view, extensive forms of regulation, including command and control mechanisms, are needed even for transactions that involve only sophisticated parties, and even more so, in order to protect the small investor from various

* James Parker Hall Distinguished Service Professor of Law, The University of Chicago; The Peter and Kirsten Bedford Senior Fellow, The Hoover Institution. A.B. 1964, Columbia College; B.A. 1966, Oxford University; LL.B. 1968, Yale University; LL.D. 2003, University of Ghent. My thanks to Jeana M. Bisnar, New York University Law School, Class of 2010, for her instantaneous and able research assistance.

1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

forms of abuse. To be sure, within this arena, we need not enter the larger debate over whether we should welcome private capital markets at all. The only question is the nature and extent of the regulation needed to combat fraud and other sharp practices.

Many of these major regulatory schemes must be rethought with the rise of global markets, which surely changes the mix of sophisticated and unsophisticated investors. If any antifraud system of regulation makes sense, then we should expect to draw foreign capital and investors into the United States, for sophisticated investors around the globe crave confidence in the probity of capital markets. But if that assumption on extensive, or new, levels of regulation turns out to be wrong, foreign investors should reduce their position in the United States in light of the dislocation that regulation creates. The direction of capital flows should give strong indication as to the *net* benefit of the package of legislation, even if it will not allow us to decide which particular reforms or practices are desirable and which not.

To set the stage, let me first deal with some of the common misconceptions of regulation, of which it is possible to identify four. The first deals with the unstated depreciation rates of regulation. The second addresses the supposedly inelastic response to regulation. The third deals with the underappreciation of future regulation. The fourth deals with the indirect consequences of regulation. Once this is done, I shall talk about the legal upshot in both administrative and constitutional law that follows from these wrong conceptions: strong deference to government actors, which accelerates the rate of direct regulation, and with it the level of capital flight from the domestic public securities market. Next, I shall evaluate how this framework applies in two concrete situations: the basic design of the securities acts, and the rise of the independent director. The last section then explains why the cumulative impact of these reforms has been to reduce the attractiveness of United States securities markets on the world stage.

II. COMMON MISTAKES ON REGULATION

A. *Regulatory Depreciation*

The first of the pitfalls associated with regulatory interventions is that of hidden depreciation. Regulation, especially good regulation, should be thought of as a kind of social asset. Its value is determined like that of any other asset. What is the value of the system when it is first put into place? And what is its rate of depreciation (or, occasionally, appreciation) over time? There are some statutes, which have high initial values and low, even nonexistent rates of depreciation. My favorite example is the Statute of Frauds, circa 1677,² which retains its value with real estate transactions to the present day. The reason for this impressive durability is that the statute only requires certain simple formalities—written instruments signed by the party to be charged—whose value *increases* as underlying deals become more valuable and more complex. Stated otherwise, the Statute of Frauds retains its power because it offers a simple set of intuitive precautions that facilitate, not frustrate, voluntary transactions. Other regulatory schemes of course have more interventionist ambitions, and these are more likely to depreciate at a very high rate. Unfortunately, regulation, unlike market behaviors, does not have the key advantage of decentralized self-correction. To give but one example, the recent Telecommunications Act of 1996³ was predicated on the assumption that land-based telephones would remain dominant, so that regulation of local exchange carriers was the key to breaking down their “last mile” advantage. Sorry. The improvement in cell phones, the rise of VOIP telephony and a thousand other innovations, large and small, have rendered that framework obsolete. Today landlines are shrinking both in absolute numbers and as a percentage of total service. Yet twelve years later, there is no assurance that the Congress will pass the next generation of regulatory controls, given the new interest groups that have emerged. Securities regulation is not immune from the same rate of depreciation, given the vast technological transformation of trading technologies.

2. Statute of Frauds, 1677, 29 Car. II., c. 3.

3. Telecommunications Act of 1996, Pub. L. No. 104-404, 110 Stat. 56 (codified as amended in scattered sections of 47 U.S.C.).

B. *Inelastic Private Responses to Regulation*

A second mistake often made by modern defenders of regulation is to assume that most private markets are marked by an enormous amount of firm inelasticity; there is, in other words, relatively little private response to government regulation. Here is one domestic example. A typical defense of the minimum wage runs as follows: if one paid workers seven dollars an hour, and if one raises it to nine dollars an hour, one pays workers an extra two dollars an hour. The total wage bill is a simple exercise in mathematics. If there were 100 workers before the wage increase, there would be 100 workers after it, so that the total wage bill would increase by \$200, leaving everything else unchanged. Few people will utter the proposition in this mathematical form, but it is implicit any account that insists that minimum wages “help” or “protect” all workers. Accordingly, the conscientious regulator need not worry about whether employers are going to reduce the number of employed workers in response to the mandated wage increase.

In so doing, however, they make the fatal mistake of assuming that small (or even not so small) changes in regulation have no effect on private decisions. One way to put this point is to ask the question of whether there would be any change in employment levels if the minimum wage level were set a single penny above the prevailing market wage. The obvious response is, who would fire a worker to save a cent? But what about the second cent and the third? That said, it does seem clear that the \$2.00 raise will have some consequences, even though it is simply the sum of 200 penny increases. If so, then the question arises: how can the totality of these increases matter, when each component of them does not? And to that challenge there is really no reply.

The key point to extract from this example is that, as the price increases, the quantity demanded goes down. Any demand function is continuous and monotonically declining, even if it is not linear. Each increase in prices, whether required or voluntary, will produce a decrease in demand. It does not follow, however, that for infinitesimal increases in price, there will be an observed decrease in quantity. All that can be said with complete confidence is that there is always a positive probability, even one that is tiny, that any price increase will produce that associated

quantity reduction. As the intervals get larger, the results become inexorable. And we know from politics that no one will invest the political capital to make infinitesimal changes. We should therefore in all real-world settings observe the changes in supply. And the same arguments apply to changes in the quantities supplied as a function of price. There are no "safe" intervals where regulation can operate to provide protection in one dimension—e.g. price—without generating risks in another—e.g. quantity. And what happens for monetary changes applies with equal force to regulatory burdens that always cash out to some monetary equivalent. The only questions therefore to worry about are the extent of the changes, never their existence.

Therefore, the naïve regulator who starts with the initial assumption of an inelastic response is always going to opt for more extensive systems of regulation than will prove in practice to be sustainable in the long run. In contrast, anyone who starts from the opposite assumption—namely, that individuals and firms are always on a slope, and never on flat terrain—will be more cautious in designing regulatory schemes because of the abiding fear that regulated parties will respond in ways that undermine the regulatory objectives. The quantity demanded of *anything* goes down as the price goes up—regulation included. At this point the arguments play out just as they did with the minimum wage. Magnitudes matter in regulation. Modest regulations will not generate much of a difference. Extensive schemes will. Beware of any argument that says a small change just makes "no difference."

C. Anticipated Additional Regulation

A third caveat also applies with special force to new regimes of taxation and regulation. The impact of a modest regulation must be thought of not only in a static, but also in a dynamic sense. A new small tax or regulation will generate a modest response only if the regulated parties are confident that the severity of the tax or regulation will not increase with time. But in a world with few binding constitutional protections against regulation or taxation, that simplifying assumption is likely to prove wrong. In particular, regulated parties that have to make front-end investments lasting several years are always afraid of the camel that gets his nose inside of the tent. Before the onset

of the new regulation, the regulatory environment looked constant. But once the new regulation is in place, then the political dynamics change. To get the regulation through, regulators will assure people that conscientious regulators will keep it mild so that there is nothing to fear. No firm guarantees, of course.

Stage two can quickly follow. Once the regulation is in place, the argument then switches. The earlier promises of restraint are forgotten. Or it is said that changed circumstances requires more aggressive intervention. At the same time, the initial approval of the regulation is said to put to rest all doubts as to its wisdom in principle, or when relevant, to its constitutionality. The only question is the matter of severity or degree, or the very type of decision that has to be left to political, not judicial bodies. The upshot is that the initial round of regulation (or taxation) is used to establish the program, after which increases are easier to come by. The political strategy is to get to a high-regulation or high-taxation regime in two stages rather than one. And if regulated (or taxed) parties perceive that this two-step will take place, their response in the initial period will reflect their anxiety of future government action. In dealing with regulation, therefore, the disputes will be telescoped. The resistance to the initial regulation (like its support) will reflect the discounted probability of more exacting amendments, just as it would for the (less likely) prospect of repeal. The battle will be more intense than one might suppose and so too the magnitude of its effect. There are no secrets in a world in which a second wave of regulation can follow the first. The regulator who misses these tendencies, and therefore assumes that regulated parties have short time horizons, will systematically underestimate the rate at which capital moves across jurisdictional boundaries, both within the United States and internationally.

D. *Direct and Indirect Consequences*

A fourth common mistake of regulators is to assume that the indirect consequences of regulation are small and can therefore be safely ignored. If, however, what I contend with respect to elastic responses to regulation is correct, then indirect consequences are likely to undermine the efforts of regulators to confine the private responses to some narrow domain. Here the

simple observation is this: regulation will surely influence the supply and demand of the regulated goods and services. But in addition, it will exert a powerful influence over the supply and demand of all the complements to and all the substitutes for the regulated goods or activities. These cascade effects will add up very quickly, carrying with them the potential to set up alternative business regimes that are beyond regulation. Or alternatively, where the substitutions are difficult to arrange, the regulations could cripple those activities that are heavily dependent of the vitality of the regulated sector. Drive financial activities out of the United States, and the large investment banks may follow their clients overseas. But many local employees and real estate owners will have fewer options, and will therefore be caught in a heavy downdraft.

The reason for these diverse responses is not hard to see. Think of the current system as one that is in relative equilibrium. The question now is what adaptive responses will take place if a regulator adds one (or more) powerful constraint onto the system. The simple truth is that the tighter the constraint the more extensive the disruptions for the regulated parties and for those who do business with them. Any stress on these indirect consequences helps legitimate a regime of *laissez-faire*. All too often the regulators listen to those people who claim that they should receive special protection because of the dislocation that comes from market forces, often generated by persons who have less political clout than they do. The dozen victims of market innovations are easy to see when they are let go from bankrupt firms. The hundred winners from the new innovations that may never take place cannot come forward to defend their interests in person before political bodies. The visible persons hurt by ruinous competition can easily wring special concessions from legislators that slow down the technological or business shifts or give some special compensation packages to those who are displaced by them. Taking into account only the position of the visible losers—e.g., those displaced by mortgage foreclosure—gives a systematically misleading account of what should be done. This response could in the end negatively influence the willingness of foreign investors to place their capital in American markets. All too often, the unwillingness, or inability, to take into account these indirect effects leads to systematic overregulation.

III. PAYING THE PIPER: DEFERENCE TO THE "GOOD FAITH" REGULATOR

The four mistakes that I have just outlined have important consequences for the shape of American law, as it operates in both the domestic and international arenas. In a world in which the pitfalls of regulation are constantly understated, it is easy to defend the general proposition that regulators who act in good faith should be given the benefit of the doubt. That simple proposition manifests itself in countless ways in our current legal system. At the constitutional level, it tends to neuter all challenges to regulation based on the traditional ground that they interfere unduly with liberty and property. In the end, therefore, federal and state regulators have *carte blanche* to decide whether the interference is justified. At the administrative law level, it can easily lead to a form of extreme deference to administrative agencies, now embodied in *Chevron U.S.A. Inc. v. Natural Resource Defense Council, Inc.*,⁴ on the grounds that their supposed expertise and neutrality should not be attacked by courts that cannot hope to understand the complexity of the underlying issues.

This one-two punch has had a powerful influence on American law, so much so that it is virtually impossible to mount a successful challenge to any major regulatory scheme no matter how perverse and anticompetitive its effects. The same courts that often do a good job figuring out which business practices are anticompetitive under the antitrust laws are now wholly unable to bring the same analytical tools to bear on various forms of administrative regulation. Most judges are now aware of the anticompetitive effects of any antitrust decisions that are justified on the ground that they restrict predatory practices.⁵ But let them don their constitutional hats, and they are unable to find themselves unable, or unwilling, to mount any attack on

4. *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) (deciding that where a statute is unclear, courts should defer to the agency's permissible construction of the statute).

5. See, e.g., *Weyerhaeuser Co. v. Ross-Simmons*, 127 S. Ct. 1069 (2007); *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986); *Bell Atlantic Corp. v. Twombly*, 127 S. Ct. 1955 (2007).

grotesque systems of cartelization that characterize so much legislative activity.⁶

In adopting this deferential stance, modern constitutional law turns the great insight of Frederic Bastiat on its head. Bastiat thought of government as a device that lets each person put his hand into the pocket of his neighbor.⁷ That happens all too often, but in fact one, perhaps "the," reason people need government is that the mutual renunciation of private force, which cannot be achieved by voluntary agreement alone, creates genuine Pareto improvements,⁸ even after taking into account the taxes that are needed to make this regulation function. Given the evident existence of at least some Pareto improvements, the task of the regulator is to figure out whether or not their new legal regime has created a rising tide for all ships or whether or not that regime has simply shifted the ballast from one side of the ship to the other. Too much tilt and the ship is in danger of capsizing, which could lead to some adjustments to reestablish a preferred balance.

The twin assumptions of rational basis constitutional law and *Chevron* deference administrative law now take on a more ominous interpretation. The passionate defenders of big government have made the (undeserved) presumption of good faith well nigh irrefutable. Courts are all too willing to assume that regulation raises all ships equally, or alternatively, it does not matter whether it does or not. But there is an unfortunate feedback loop between the level of judicial review and the quality of the regulation. The less courts scrutinize the way in which regulation takes place, the more likely it is that the legislature will pass faction-ridden regulation. While the cat is away, the mice will play.

IV. SECURITIES REGULATION AND SARBANES-OXLEY

How then do these difficulties play out in connection with the present regulation of securities markets? Here let me make only

6. See, e.g., *Parker v. Brown*, 317 U.S. 341 (1943) (establishing that restraint of trade or monopolization resulting from valid governmental action, as opposed to private action, does not violate the Sherman Act).

7. FREDERIC BASTIAT, *The State*, in *SELECTED ESSAYS ON POLITICAL ECONOMY* 140, 144 (1964) ("The state is the great fictitious entity by which everyone seeks to live at the expense of everyone else.").

8. A Pareto improvement is an improvement to one aspect of a system that does not harm any other aspect.

two points. The first concerns the rate of depreciation of old regulation and the second concerns the dangers associated with regulatory innovation.

A. Down with the Small Investor!

On the first issue, begin with this heretical question: why do we need the Securities Exchange Commission (SEC) anyway? Essentially, in 1932 the market had a large number of small individual traders, and there was the real question about whether or not they could be bilked or cheated with wash sales and lots of other market manipulations to which direct regulation could provide a helpful antidote.⁹ But let us assume that the system made sense when first introduced. Is there any reason to think that it is not completely obsolete today? I put aside here such ridiculous and outdated practices of sending various proxies and reports through the mails, to talk about the more fundamental question of when regulation works and when it does not.

The key premise is this: no unitary system of regulation works well with respect to heterogeneous communities and trading. Stated otherwise, the larger the variation in the regulated population, the less effective is any resort to one-size-fits-all models. The point surely applies to capital markets in which all may participate. There are, beyond doubt, dolts on the one hand and whizzes on the other. One cannot create a uniform set of rules that works for everybody, and the only way one can stop this is basically to adopt a new policy that sharply reduces the mandate of the Securities and Exchange Commission. The small investor be damned, to paraphrase Mr. Vanderbilt.¹⁰ Updated and sanitized, what that proposition says to members of the unwashed public is that they should let others invest on their behalf, be it through a mutual fund, a financial representative, or any other cooperative that they might choose to join. Knowing that these options are available in abundance, the SEC will craft its rules not for slowpokes but only for speed demons

9. See, e.g., Banking Act of 1933, Pub. L. No. 73-65, 48 Stat. 162; Jonathan Z. Cohen, Comment, *The Mellon Bank Order: An Unjustifiable Expansion of Banking Powers*, 8 ADMIN. L.J. AM. U., 335, 335 (1994) (criticizing the expansion of regulations implemented in response to the Great Depression).

10. Michael Binyon, *The Right Kind of Lines on the Track*, THE TIMES (London), May 27, 2006, at 12.

because anyone can hire a speed demon. At that particular point, all professional players—the Fidelitys and the Smith Barneyes—can be subject to an explicit array of fiduciary obligations that by contract protect investors from various forms of abuse. Once this is done, the SEC operates on principles akin to NASCAR insofar as it superintends only professional drivers. Uniform ability allows for higher speeds, in driving and exchange transactions. A fundamental reorientation of the whole SEC is manifestly in order.

B. Independent Directors

The errors in institutional design deal not only with the large questions, but also smaller, but still critical, issues. One of the buzz words of the past decade or so has been the claim that a sound Board of Directors requires a large dose of independent directors.¹¹ But what is the source of this claim? Once again all boards are not the same, so that the only theoretical prediction that we can make is this: different boards require different mixes of inside and outside directors. The "right" answer in any case will depend on a full array of factors. What are the core competences of current members of the corporate management? How many outsiders are available? What sorts of challenges face the corporation, and so on? So sometimes they are and sometimes they are not. Or more accurately, in some cases, more or fewer outside directors could be called for. The hard challenge for regulation asks this question: what information does Congress or the SEC, or indeed any specialized body, have about the proper mix for a particular firm? The fact that we see variation in responses does not mean that some firms lag behind another. It is just more proof of the risks in following any one-size-fits-all approach. Let those who bear the consequences of any mistakes make the choices.

Unfortunately, the current regime pushes in the opposite direction. The moment these outside directors are conceived as saviors, they will be subject to additional duties that are likely to scare competent people away.¹² Thus the law makes it harder to

11. See Sarbanes-Oxley Act § 301 (creating independence requirements for members of public company audit committees).

12. See, e.g., Sarbanes-Oxley Act § 305 (codified as amended in scattered sections of 15 U.S.C.) (Officer and Director Bars and Penalties); *id.* at § 1105 (Authority of the Commission to Prohibit Persons from Serving as Officers or Directors).

recruit independent directors. Then their duties are so onerous that they lose their independence. This movement does not count as progress, but as yet another illustration of the law of unintended consequences.

The explanation for this change is easy to identify. The political situation was most propitious for the passage of Sarbanes-Oxley, for the Bush administration was under heavy political pressure to “do something” about the corporate scandals, such as Enron and WorldCom, that occurred in the previous few years.¹³ So its short-term decision is driven by tactical considerations relevant to the then upcoming off-year 2002 election, without any real consideration to its long term implications on the structure of capital markets. True to form, the regulation is defended in part for its prudence, but it produces more dramatic responses than many had anticipated.

Once the legal rules are put into place, the private parties are faced with developing internal controls and practices that are perceived as needed to deal with civil, and perhaps even, criminal liability. I can recall speaking at meetings of corporate directors where the anxiety levels were so high that people were worried whether they could keep their own handwritten notes without fear of incurring additional risks of liability.

V. THE PREDICTABLE CONSEQUENCES

The uncertainty about the statute has, of course, ramifications in the international market. The direct costs of compliance are high, but these do not exhaust the total costs. Firms that are worried constantly about potential civil and criminal litigation develop defensive postures. Their boards are less concerned with innovation and more concerned with compliance. That mission shift does not go unnoticed by firms that have options to relocate overseas, so the American capital markets lose two ways. Some firms decide that it is better to delist on the American exchanges than to pay the costs of compliance. Others decide that they will not operate in the United States at all. Still others decide that they prefer to go private in order to avoid the strain. Still others decide to avoid or delay going public for the same reason.

13. Scott Woolley, *Feel-Good Justice*, FORBES, June 23, 2003, at 52.

What is going on here? For many years, the United States had a strong reputation as the home of capital markets. In part, this was due to the general corruption-free environment. In part, it was due to weaknesses that existed in overseas markets. There is little that the United States can do to prevent the improvements in regulation or financial sophistication by its overseas competitors. But there is much that it can do to deal with the situation within its borders. And it hardly helps the situation for outsiders to doubt that the United States offers a hospitable regulatory environment, only to discover that they would be well advised to take sovereign risk as a serious issue. And once foreign investors anticipate sovereign risk, one rational response is for them to diversify their holdings away from the risky sovereign in order to be able to play one sovereign off against another. Just that perception is enough for U.S. capital markets to lose their dominant position.¹⁴ These intangible reputation losses are hard to reverse, especially when other nations turn out to provide services comparable to our own.

The fear of regulation thus induces other forms of behavior. If public offerings carry with them serious risks, then firms will seek ways to minimize those risks. One response is to interpose new entities between the public and the new offering. Thus firms that specialize in making private offerings to pension funds and large insurance companies adopt just this strategy. The new approach is to strike deals with large entities that represent many individuals,¹⁵ not dealing with the individuals themselves. In effect, the private model implements the approach the SEC should take toward the storied small investor.

The consequences of this shift are hard to evaluate. Perhaps this strategy, which slights public offerings, would be preferred in any regulatory environment. But there is some reason to think that this is not the case. After all, public offerings were once more common than they are today,¹⁶ there are some efficiency losses that follow when the shift is induced by

14. See SOVEREIGN RISK AND FINANCIAL CRISES (Michael Frenkel, Alexander Karmann & Bert Scholtens eds., Singer Publishing 2004) (discussing diversification as a response to sovereign risk).

15. See Kasper Meisner Nielsen, *Institutional Investors and Private Equity*, 12 OXFORD REV. OF FIN. 185 (2008) (discussing the high degree of investment in private equity markets by hedge funds and other institutional investors).

16. Allyce Bess, *Bakers Footwear Makes Imprint on NASDAQ, Its First St. Louis-Area IPO in Two Years*, ST. LOUIS POST-DISPATCH, Feb. 6, 2004, at C1.

regulation and not by market forces. To be sure, diversification may be preserved in at least some cases, but now two layers of entities are needed in order to achieve this result instead of one. The shift thus creates more intrinsic friction and reduces the level of public disclosure and hence of public awareness. No one should suppose that unregulated public equity markets will outperform private equity markets every time, but the moment regulation changes the relative costs of doing business, collateral consequences will follow. Koch Industries Inc. will take over Georgia-Pacific Corp. rather than the other way round, so that we now have one private company with at a guess \$90 billion in annual sales that issues no disclosure statements at all.¹⁷

But what if the firms cannot hide? Now some—it is hard to say how many—will run for shelter elsewhere. Where? Perhaps to Hong Kong, London or other places that do not have our regulatory system.¹⁸ These countries may lack our constitutional structures, but of what value are these when the level of protection that the United States affords to property rights is so diluted that they are always subject to political risks. Our weak constitutional structure gives us no comparative advantage in the current round of international competition.

The right structural move now seems clear. Treat “investor protection” as a double-edged sword, and slow it down. Once and for all, we must slay the bogeyman that more regulation means more protection. All too often, we do right by doing less, not more.

17. Koch Industries, <http://www.kochind.com/default.asp> (last visited May 20, 2008).

18. See generally COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION (2006), available at www.capmksreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf; MCKINSEY & COMPANY, SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP (2007), available at www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf (discussing the shift in investment activity from the US to foreign markets).