Equity Regulation and U.S. Venture Capital Investment

John V. Duca

Federal Reserve Bank of Dallas
john.v.duca@dal.frb.org

Tyler Atkinson
Federal Reserve Bank of Dallas

There is a growing consensus that the long-run per capita growth rate of the U.S. economy has drifted lower since the early 2000s, consistent with a perceived slowdown in business dynamism. One factor that may have contributed to this is a downshift in venture capital investment and its failure to recover in line with stock prices, as pre-2003 patterns would suggest. Critics have argued that this is associated with the increased regulatory burden for publically traded firms to comply with the Sarbanes-Oxley Act of 2002 (SOX). There is inconclusive evidence of SOX deterring firms from becoming publically traded as indicated by IPO activity, a proxy reflecting several factors that may not be as tied to innovation as venture capital. Earlier tests of SOX's impact on venture capital activity, which tended to focus on cross-sectional evidence, were hampered by a short time-series sample following the Internet-stock bust of the early 2000s. Taking advantage of the large-sized rise, fall, and recovery in stock prices since then, this study assesses whether the time-series behavior of venture capital investment shifted following SOX. We find evidence of a time-series break in the middle of our sample, consistent with the passage of SOX. Estimates indicate that the slower post-SOX pace of venture capital investment is mainly attributed to a reduced elasticity of such investment with respect to stock prices rather than to a simple downshift in the level of investment. Our estimates suggest that a cost-benefit analysis of SOX could be worthwhile, especially given concerns that the long-run growth rate of U.S. productivity and GDP has been unusually sluggish and the emerging consensus that excessive debt financing—not equity financing—is more tied to the subset of financial crises associated with severe macroeconomic downturns.